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Washington, Friday, February 10, 1939

The President

Closed Area Under the Migratory Bird Treaty Act—Louisiana

BY THE PRESIDENT OF THE UNITED STATES OF AMERICA

A PROCLAMATION

WHEREAS the Secretary of Agriculture has submitted to me for approval the following regulation adopted by him on January 9, 1939, under authority of the Migratory Bird Treaty Act of July 3, 1918 (40 Stat. 755):

Regulation Designating as Closed Area Part of Lacassine Bayou Adjacent to Lacassine Migratory Waterfowl Refuge, Louisiana

By virtue of and pursuant to the authority vested in me by section 3 of the Migratory Bird Treaty Act of July 3, 1918 (40 Stat. 755, 16 U. S. C. 704), I, H. A. Wallace, Secretary of Agriculture, do hereby designate as a closed area in or on which pursuing, hunting, taking, capturing, or killing, or attempting to take, capture, or kill migratory birds is not permitted, all that part of Lacassine Bayou from its intersection with the north boundary of Sec. 15, T. 12 S., R. 5 W., Louisiana Meridian, to its mouth or point of confluence with Grand Lake, and lying adjacent to the areas in Cameron Parish, La., established as the Lacassine Migratory Waterfowl Refuge, by Executive Order No. 7780, dated December 30, 1937;[1]

AND WHEREAS upon consideration it appears that the foregoing regulation will tend to effectuate the purposes of the aforesaid Migratory Bird Treaty Act of July 3, 1918:

NOW, THEREFORE, I, FRANKLIN D. ROOSEVELT, President of the United States of America, under and by virtue of the authority vested in me by the aforesaid Migratory Bird Treaty Act of July 3, 1918, do hereby approve and proclaim the foregoing regulation of the Secretary of Agriculture.

IN WITNESS WHEREOF I have hereunto set my hand and caused the seal of the United States of America to be affixed.

DONE at the City of Washington this seventh day of February in the year of our Lord nineteen hundred and thirty-nine, and of the Independence of the United States of America the one hundred and sixty-third.

[SEAL]

FRANKLIN D ROOSEVELT

By the President:

CORDELL HULL
Secretary of State.

[No. 2322]

[F. R. Doc. 39-475; Filed, February 9, 1939; 12:31 p. m.]

[1] 3 F. R. 1 DI.

Rules, Regulations, Orders

TITLE 10—ARMY

WAR DEPARTMENT

Chapter I—Aid of Civil Authorities and Public Relations

PART 7—MANUFACTURE OF DECORATIONS[1a] #

SEC. 7.01 *General.* Under the authority contained in the act of February 24, 1923 (42 Stat. 1286), as amended by act April 21, 1928 (45 Stat. 437); 10 U. S. C. 1425; The Adjutant General, by authority of the Secretary of War under regulations hereinafter prescribed, will grant certificates of authority to private individuals, firms, and corporations for the sale or the manufacture and sale of service medals, service ribbons, miniatures, miniature oak-leaf clusters, bronze stars, lapel buttons, badges, War Department General Staff identification, and similar articles covered by the act.* #

SEC. 7.02 *Decorations may not be manufactured or sold.* No authority will be granted to any private individual, firm, or corporation to sell or to manufacture and sell the Congressional Medal of Honor, the Distinguished-Service Cross, the Distinguished-Service Medal, the Silver Star, the Purple Heart, the Soldier's Medal, the Distinguished-Flying Cross,

[1a] These regulations supersede Part 7, Title 10, Code of Federal Regulations.

* Sections 7.01 to 7.10 issued under the authority contained in 42 Stat. 1286, as amended by 45 Stat. 437; 10 U. S. C. 1425.

#The source of sections 7.01 to 7.10 is AR 600-90, December 23, 1938.

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BUREAU OF INTERNAL REVENUE

[Regulations 101]

INCOME TAX UNDER THE REVENUE ACT OF 1938

INTRODUCTORY

These regulations deal with the income tax imposed by the Revenue Act of 1938.

The main body of these regulations deals with Titles I, IA, and VI of that Act. Certain provisions of the Act found in Titles III and V and regulations interpretative thereof have been inserted in the Appendix, for example, section 820, relating to mitigation of effect of limitation and other provisions in income tax cases, and section 602, relating to the excess-profits tax. In addition, certain general provisions of prior Acts, and the regulations issued thereunder, which are applicable to the income taxes imposed by the Revenue Act of 1938, have been inserted in the Appendix. The table of contents immediately preceding the Appendix shows the scope and nature of the material included therein.

The numbering of the respective articles in the body of the regulations follows the plan adopted in Regulations 86, prescribed under the Revenue Act of 1934, and used in Regulations 94, prescribed under the Revenue Act of 1936. In accordance with this plan, the numbers of the sections of the Act are used as key numbers, followed by a dash (–), with the number of the article placed after the dash. By this means anyone who desires to learn how a given section or subsection of the Act has been interpreted by the Bureau can readily and quickly find that interpretation by using the key number. Thus, if one desires to learn what interpretation has been placed on section 21 of the Act, he should turn to article 21–1 of the regulations. In some cases several articles are necessary in the interpretation of different phases of one section or subsection or paragraph of the Act. For example, section 23 (m), dealing with "Depletion," requires many articles. Each of them, however, is designated by the key 23 (m); for example, article 23 (m)–1, article 23 (m)–2.

The regulations proper have been divided into chapters. The material to be found in each respective chapter is shown in the "Contents." The classification of the material by chapters follows the arrangement of the corresponding sections of the Act.

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CHAPTER I

Scope of Regulations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act, divided into titles and sections according to the following Table of Contents, may be cited as the "Revenue Act of 1938":

* * * * *

Title I—Income Tax, Subtitle A—Introductory Provisions

SEC. 1. *Application of title.*—The provisions of this title shall apply only to taxable years beginning after December 31, 1937. Income, war-profits, and excess-profits taxes for taxable years beginning prior to January 1, 1938, shall not be affected by the provisions of this title, but shall remain subject to the applicable provisions of prior revenue Acts, except as such provisions are modified by Title V of this Act or by legislation enacted subsequent to this Act.

ARTICLE 1-1. *Scope of regulations.*—These regulations deal with the taxes upon net income imposed by Title I of the Revenue Act of 1938, including the tax imposed by section 102 of Title I of that Act upon the net income of certain corporations, and the tax imposed by Title IA of that Act upon the undistributed adjusted net income of personal holding companies (see section 401).

The articles of these regulations have been given key numbers corresponding to the numbers of the sections, subsections, or paragraphs of the Act. For example, articles 23 (a)-1 to 23 (a)-13, relating to deduction for expenses, bear the key number 23 (a), which corresponds to subsection 23 (a) of the Act. The articles bearing a given key number are the regulations prescribed with respect to the corresponding section, subsection, or paragraph of the Act; and the section, subsection, or paragraph of the Act shall be considered as a part of the respective articles to which it corresponds.

SEC. 2. *Cross references.*—The cross references in this title to other portions of the title, where the word "see" is used, are made only for convenience, and shall be given no legal effect.

SEC. 3. *Classification of provisions.*—The provisions of this title are herein classified and designated as—

Subtitle A—Introductory provisions.
Subtitle B—General provisions, divided into Parts and sections.
Subtitle C—Supplemental provisions, divided into Supplements and sections.

ART. 3-1. *Division of regulations.*—These regulations have been divided into 38 chapters. Chapter I relates to Introductory Provisions, Subtitle A of Title I. Chapters II to IX relate to General Provisions, Subtitle B of Title I. Chapters X to XXII relate to Supplements A to D of Supplemental Provisions, Subtitle C of Title I. Chapters XXIII to XXIX relate to Supplements E to K of Supplemental Provisions, Subtitle C of Title I. Chapters XXX to XXXVI relate to Supplements L to R of Supplemental Provisions, Subtitle C of Title I. Chapter XXXVII relates to Title IA, Surtax on Personal Holding Companies. Chapter XXXVIII relates to Title VI, General Provisions of the Act.

SEC. 4. *Special classes of taxpayers.*—The application of the General Provisions and of Supplements A to D, inclusive, to each of the following special classes of taxpayers, shall be subject to the exceptions and additional provisions found in the Supplement applicable to such class, as follows:

(a) Estates and trusts and the beneficiaries thereof.—Supplement E.
(b) Members of partnerships.—Supplement F.
(c) Insurance companies.—Supplement G.
(d) Nonresident alien individuals.—Supplement H.
(e) Foreign corporations.—Supplement I.
(f) Individual citizens of any possession of the United States who are not otherwise citizens of the United States and who are not residents of the United States.—Supplement J.
(g) Individual citizens of the United States or domestic corporations, satisfying the conditions of section 251 by reason of deriving a large portion of their gross income from sources within a possession of the United States.—Supplement J.
(h) China Trade Act corporations.—Supplement K.
(i) Foreign personal holding companies and their shareholders.—Supplement P.
(j) Mutual investment companies.—Supplement Q.

ART. 4-1. *Application of regulations to special classes of taxpayers.*—With respect to certain classes of taxpayers, the application of the provisions of Chapters II to XXII is subject to certain exceptions and additional provisions, which are discussed in Chapters XXIII to XXIX and Chapters XXXIV and XXXV, as follows:

Chapter XXIII—Estates and trusts.
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Chapter XXV—Insurance companies.
Chapter XXVI—Nonresident alien individuals.
Chapter XXVII—Foreign corporations.
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For provisions interpretative of Title IA, surtax on personal holding companies, see articles 401-1 to 409-2, inclusive. For provisions relating to the taxation to shareholders of the income of foreign personal holding companies and requiring certain information returns, see articles 331-1 to 339-3, inclusive. For provisions relative to surtax on corporations improperly accumulating surplus, see articles 102-1 to 102-4, inclusive.

CHAPTER II

Rates of Tax

Subtitle B—General Provisions, Part I—Rates of Tax

SEC. 11. *Normal tax on individuals.*—There shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 4 per centum of the amount of the net income in excess of the credits against net income provided in section 25.

ART. 11-1. *Income tax on individuals.*—Title I of the Act, which applies only to taxable years beginning after December 31, 1937 (see section 1), imposes an income tax on individuals, including a normal tax (section 11) and a surtax (section 12). The tax is upon net income which is determined by subtracting the allowable deductions from the gross income. (See general sections 21-24.) In certain cases credits are allowed against the net income before computing the tax (section 25) and in other cases against the amount of the tax (sections 31, 32, and 131). In general, the tax is payable upon the basis of returns rendered by persons liable thereto (sections 51, 53, 142, and 217), except that in some instances it is to be paid at the source of the income (section 143). Exceptions and additional provisions applicable to certain special classes of taxpayers are listed in section 4. See section 102 as to shareholders of corporations formed or availed of to prevent imposition of surtax.

See Supplement P as to shareholders of foreign personal holding companies. See section 117 as to the treatment of capital gains and capital losses.

ART. 11-2. *Citizens or residents of the United States liable to tax.*—In general, citizens of the United States, wherever resident, are liable to the tax, and it makes no difference that they may own no assets within the United States and may receive no income from sources within the United States. Every resident alien individual is liable to the tax, even though his income is wholly from sources outside the United States. As to nonresident alien individuals, see sections 211-219.

ART. 11-3. *Who is a citizen.*—Every person born or naturalized in the United States, and subject to its jurisdiction, is a citizen. When any naturalized citizen has left the United States and resided for two years in the foreign country from which he came, or for five years in any other foreign country, it is presumed that he has ceased to be an American citizen. This presumtpion does not apply, however, to residence abroad while the United States was at war, nor does it apply in the case of individuals born in the United States subject to its jurisdiction. However, even though an individual born in the United States, subject to its jurisdiction, of either citizen or alien parents, resided in a foreign country for a number of years, he would still be a citizen of the United States, unless he had become naturalized in, or taken an oath of allegiance to, the foreign country of residence or some other foreign state. A foreigner who has filed his declaration of intention of becoming a citizen of the United States but who has not yet received his final citizenship papers is an alien. See articles 211-2 to 211-5 for distinction between a resident alien individual and a nonresident alien individual.

SEC. 12. *Surtax on individuals.*—(a) *Definition of "surtax net income".*—As used in this section the term "surtax net income" means the amount of the net income in excess of the credits against net income provided in section 25 (b).

(b) *Rates of surtax.*—There shall be levied, collected, and paid for each taxable year upon the surtax net income of every individual a surtax as follows:

Upon a surtax net income of $4,000 there shall be no surtax; upon surtax net incomes in excess of $4,000 and not in excess of $6,000, 4 per centum of such excess.

$80 upon surtax net incomes of $6,000; and upon surtax net incomes in excess of $6,000 and not in excess of $8,000, 5 per centum in addition of such excess.

$180 upon surtax net incomes of $8,000; and upon surtax net incomes in excess of $8,000 and not in excess of $10,000, 6 per centum in addition of such excess.

$300 upon surtax net incomes of $10,000; and upon surtax net incomes in excess of $10,000 and not in excess of $12,000, 7 per centum in addition of such excess.

$440 upon surtax net incomes of $12,000; and upon surtax net incomes in excess of $12,000 and not in excess of $14,000, 8 per centum in addition of such excess.

$600 upon surtax net incomes of $14,000; and upon surtax net incomes in excess of $14,000 and not in excess of $16,000, 9 per centum in addition of such excess.

$780 upon surtax net incomes of $16,000; and upon surtax net incomes in excess of $16,000 and not in excess of $18,000, 11 per centum in addition of such excess.

$1,000 upon surtax net incomes of $18,000; and upon surtax net incomes in excess of $18,000 and not in excess of $20,000, 13 per centum in addition of such excess.

$1,260 upon surtax net incomes of $20,000; and upon surtax net incomes in excess of $20,000 and not in excess of $22,000, 15 per centum in addition of such excess.

$1,560 upon surtax net incomes of $22,000; and upon surtax net incomes in excess of $22,000 and not in excess of $26,000, 17 per centum in addition of such excess.

$2,240 upon surtax net incomes of $26,000; and upon surtax net incomes in excess of $26,000 and not in excess of $32,000, 19 per centum in addition of such excess.

$3,380 upon surtax net incomes of $32,000; and upon surtax net incomes in excess of $32,000 and not in excess of $38,000, 21 per centum in addition of such excess.

$4,640 upon surtax net incomes of $38,000; and upon surtax net incomes in excess of $38,000 and not in excess of $44,000, 24 per centum in addition of such excess.

$6,080 upon surtax net incomes of $44,000; and upon surtax net incomes in excess of $44,000 and not in excess of $50,000, 27 per centum in addition of such excess.

$7,700 upon surtax net incomes of $50,000; and upon surtax net incomes in excess of $50,000 and not in excess of $56,000, 31 per centum in addition of such excess.

$9,560 upon surtax net incomes of $56,000; and upon surtax net incomes in excess of $56,000 and not in excess of $62,000, 35 per centum in addition of such excess.

$11,660 upon surtax net incomes of $62,000; and upon surtax net incomes in excess of $62,000 and not in excess of $68,000, 39 per centum in addition of such excess.

$14,000 upon surtax net incomes of $68,000; and upon surtax net incomes in excess of $68,000 and not in excess of $74,000, 43 per centum in addition of such excess.

$16,580 upon surtax net incomes of $74,000; and upon surtax net incomes in excess of $74,000 and not in excess of $80,000, 47 per centum in addition of such excess.

$19,400 upon surtax net incomes of $80,000; and upon surtax net incomes in excess of $80,000 and not in excess of $90,000, 51 per centum in addition of such excess.

$24,500 upon surtax net incomes of $90,000; and upon surtax net incomes in excess of $90,000 and not in excess of $100,000, 55 per centum in addition of such excess.

$30,000 upon surtax net incomes of $100,000; and upon surtax net incomes in excess of $100,000 and not in excess of $150,000, 58 per centum in addition of such excess.

$59,000 upon surtax net incomes of $150,000; and upon surtax net incomes in excess of $150,000 and not in excess of $200,000, 60 per centum in addition of such excess.

$89,000 upon surtax net incomes of $200,000; and upon surtax net incomes in excess of $200,000 and not in excess of $250,000, 62 per centum in addition of such excess.

$120,000 upon surtax net incomes of $250,000; and upon surtax net incomes in excess of $250,000 and not in excess of $300,000, 64 per centum in addition of such excess.

$152,000 upon surtax net incomes of $300,000; and upon surtax net incomes in excess of $300,000 and not in excess of $400,000, 66 per centum in addition of such excess.

$218,000 upon surtax net incomes of $400,000; and upon surtax net incomes in excess of $400,000 and not in excess of $500,000, 68 per centum in addition of such excess.

$286,000 upon surtax net incomes of $500,000; and upon surtax net incomes in excess of $500,000 and not in excess of $750,000, 70 per centum in addition of such excess.

$461,000 upon surtax net incomes of $750,000; and upon surtax net incomes in excess of $750,000 and not in excess of $1,000,000, 72 per centum in addition of such excess.

$641,000 upon surtax net incomes of $1,000,000; and upon surtax net incomes in excess of $1,000,000 and not in excess of $2,000,000, 73 per centum in addition of such excess.

$1,371,000 upon surtax net incomes of $2,000,000; and upon surtax net incomes in excess of $2,000,000 and not in excess of $5,000,000, 74 per centum in addition of such excess.

$3,591,000 upon surtax net incomes of $5,000,000; and upon surtax net incomes in excess of $5,000,000, 75 per centum in addition of such excess.

(c) *Tax in case of capital gains or losses.*—For rate and computation of alternative tax in lieu of normal tax and surtax in the case of a capital gain or loss from the sale or exchange of capital assets held for more than eighteen months, see section 117 (c).

(d) *Sale of oil or gas properties.*—For limitation of surtax attributable to the sale of oil or gas properties, see section 105.

(e) *Tax on personal holding companies.*—For surtax on personal holding companies, see Title IA.

(f) *Avoidance of surtaxes by incorporation.*—For surtax on corporations which accumulate surplus to avoid surtax on shareholders, see section 102.

ART. 12–1. *Surtax.*—In addition to the normal tax imposed by section 11 a surtax is imposed at the rates specified in section 12 upon the surtax net income of every individual, resident or nonresident, except nonresident alien individuals subject to the tax imposed by section 211 (a). The surtax net income is the amount of the net income in excess of the personal exemption and credit for dependents. (See generally articles 25–1 to 25–7.) For surtax on corporations improperly accumulating surplus see section 102. As to surtax on personal holding companies, see Title IA.

ART. 12–2. *Computation of surtax.*—The following table shows the surtax due for taxable years beginning after December 31, 1937, upon certain specified amounts of surtax net income. In each instance the first figure of the surtax net income in the surtax net-income column is to be excluded and the second figure included. The percentage given opposite applies to the excess of income over the first figure in the surtax net-income column. The last column gives the total surtax on a surtax net income equal to the second figure in the surtax net-income column.

Surtax Table

Surtax net income	Percent	Total surtax
$0 to $4,000		
$4,000 to $6,000	4	$80
$6,000 to $8,000	5	180
$8,000 to $10,000	6	300
$10,000 to $12,000	7	440
$12,000 to $14,000	8	600
$14,000 to $16,000	9	780
$16,000 to $18,000	11	1,000
$18,000 to $20,000	13	1,260
$20,000 to $22,000	15	1,560
$22,000 to $26,000	17	2,240
$26,000 to $32,000	19	3,380
$32,000 to $38,000	21	4,640
$38,000 to $44,000	24	6,080
$44,000 to $50,000	27	7,700
$50,000 to $56,000	31	9,560
$56,000 to $62,000	35	11,660
$62,000 to $68,000	39	14,000
$68,000 to $74,000	43	16,580
$74,000 to $80,000	47	19,400
$80,000 to $90,000	51	24,500
$90,000 to $100,000	55	30,000
$100,000 to $150,000	58	59,000
$150,000 to $200,000	60	89,000
$200,000 to $250,000	62	120,000
$250,000 to $300,000	64	152,000
$300,000 to $400,000	66	218,000
$400,000 to $500,000	68	286,000
$500,000 to $750,000	70	461,000
$750,000 to $1,000,000	72	641,000
$1,000,000 to $2,000,000	73	1,371,000
$2,000,000 to $5,000,000	74	3,591,000
$5,000,000 up	75	

The surtax for any amount of surtax net income not stated in round figures in the table is computed by adding to the surtax for the largest amount stated which is less than the surtax net income, the surtax upon the excess over that amount at the rate indicated in the table. Accordingly, the surtax due for taxable years beginning after December 31, 1937, upon a surtax net income of $63,128 would be $12,099.92, computed as follows:

Surtax on $62,000 from table	$11,660.00
Surtax on $1,128 at 39 percent	439.92
Total	12,099.92

SEC. 13. *Tax on corporations in general.*—(a) *Adjusted net income.*—For the purposes of this title the term "adjusted net income" means the net income minus the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(b) *Imposition of tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation the net income of which is more than $25,000 (except a corporation subject to the tax imposed by section 14, section 231 (a), Supplement G, or Supplement Q) a tax computed under subsection (c) of this section or a tax computed under subsection (d) of this section, whichever tax is the lesser.

(c) *General rule.*—The tax computed under this subsection shall be as follows:

(1) A tentative tax shall first be computed equal to 19 per centum of the adjusted net income.

(2) The tax shall be the tentative tax reduced by the sum of—

(A) 16½ per centum of the credit for dividends received provided in section 26 (b); and

(B) 2½ per centum of the dividends paid credit provided in section 27, but not to exceed 2½ per centum of the adjusted net income.

(d) *Alternative tax (corporations with net income slightly more than $25,000).*—(1) If no portion of the gross income consists of interest allowed as a credit by section 26 (a) (relating to interest on certain obligations of the United States and Government corporations), or of dividends of the class with respect to which credit is allowed by section 26 (b), then the tax computed under this subsection shall be equal to $3,525, plus 32 per centum of the amount of the net income in excess of $25,000.

(2) If any portion of the gross income consists of such interest or dividends, then the tax computed under this subsection shall be as follows:

(A) The net income shall be divided into two divisions, the first division consisting of $25,000, and the second division consisting of the remainder of the net income.

(B) To the first division shall be allocated, until an aggregate of $25,000 has been so allocated: First, the portion of the gross income consisting of such interest; second, the portion of the gross income consisting of such dividends; and third, an amount equal to the excess, if any, of $25,000 over the amounts already allocated to the first division.

(C) To the second divison shall be allocated, until there has been so allocated an aggregate equal to the excess of the net income over $25,000: First, the portion of the gross income consisting of such interest which is not already allocated to the first division; second, the portion of the gross income consisting of such dividends which is not already allocated to the first division; and third, an amount equal to the excess, if any, of the net income over th sum of $25,000 plus the amounts already allocated to the second division.

(D) The tax shall be equal to the sum of the following:

(i) A tax on the $25,000 allocated to the first division, computed under section 14 (c), on the basis of the allocation made to the first division and as if the amount so allocated constituted the entire net income of the corporation.

(ii) 12 per centum of the dividends received allocated as such to the second division.

(iii) 32 per centum of the remainder of the amount allocated to the second division, except interest allowed as a credit under section 26 (a).

(e) *Corporations in bankruptcy and receivership.*—If a domestic corporation is for any portion of the taxable year in bankruptcy under the laws of the United States, or insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia, then, when the tax is computed under subsection (c), the tentative tax shall be reduced by 2½ per centum of the adjusted net income, instead of by 2½ per centum of the dividends paid credit.

(f) *Joint-stock land banks.*—In the case of a joint-stock land bank organized under the Federal Farm Loan Act, as amended, when the tax is computed under subsection (c), the tentative tax shall be reduced by 2½ per centum of the adjusted net income, instead of by 2½ per centum of the dividends paid credit.

(g) *Rental housing corporations.*—In the case of a corporation which at the close of the taxable year is regulated or restricted by the Federal Housing Administrator under section 207 (b) (2) of the National Housing Act, as amended, when the tax is computed under subsection (c), the tentative tax shall be reduced by 2½ per centum of the adjusted net income, instead of by 2½ per centum of the dividends paid credit; but only if such Administrator certifies to the Commissioner the fact that such regulation or restriction existed at the close of the taxable year. It shall be the duty of such Administrator promptly to make such certification to the Commissioner after the close of the taxable year of each corporation which is so regulated or restricted by him.

(h) *Exempt corporations.*—For corporations exempt from taxation under this title, see section 101.

(i) *Tax on personal holding companies.*—For surtax on personal holding companies, see Title IA.

(j) *Improper accumulation of surplus.*—For surtax on corporations which accumulate surplus to avoid surtax on shareholders, see section 102.

ART. 13-1. *Tax on corporations in general.*—Section 13 imposes an income tax on corporations in general the net income of which is more than $25,000. Every such corporation is liable to the tax imposed by that section, except (1) corporations expressly exempt from taxation under Title I (see section 101); (2) corporations subject to tax under section 14, being (A) corporations having net incomes of not more than $25,000, (B) banks, as defined in section 104, (C) corporations organized under the China Trade Act, 1922, (D) corporations which by reason of deriving a large portion of their gross income from sources within a possession of the United States are entitled to the benefits of section 251, and (E) foreign corporations; (3) insurance companies (see Supplement G); and (4) mutual investment companies (see Supplement Q).

It makes no difference that a domestic corporation subject to any tax imposed by section 13 may derive no income from sources within the United States. The tax imposed by section 13 is computed upon the "adjusted net income," that is, the net income as defined in section 21 minus the credit provided in section 26 (a), relating to interest on certain obligations of the United States and its instrumentalities. The term "adjusted net income" is used elsewhere in the regulations under Title I and where so used has the meaning here given to it.

The tax is payable upon the basis of returns rendered by the corporations liable thereto, except that in some cases a tax is to be paid at the source of the income (see also sections 47, 52, 53, 144, and 235). For what the term "corporation" includes and for the difference between domestic and foreign corporations, see section 901. For surtax on personal holding companies, see Title IA. For surtax on corporations improperly accumulating surplus, see section 102. For the duration of the operation of section 13, see section 15.

The tax imposed shall be computed under subsection (c) (the general rule) or subsection (d) (the alternative tax) of section 13, whichever computation produces the lesser tax. Subsection (d) is designed primarily for corporations having net incomes of slightly more than $25,000. In the case of such corporations, subsection (d) will frequently produce a lesser tax, although the result in any given case depends upon the facts and figures involved (see article 13-3).

ART. 13-2. *Tax under general rule.*—Subsection (c) of section 13 provides for the tax computation under what is termed the "general rule." A tentative tax is first computed upon the adjusted net income at the rate of 19 percent. Two credits are allowed against this tentative tax. The more important of these credits, in the majority of cases, is the one which allows a reduction in the tentative tax by 2½ percent of the dividends paid credit provided for in section 27. However, this credit may not be allowed in excess of 2½ percent of the adjusted net income. For definition of the term "dividends paid credit" and computation thereof, see article 27 (a)-1. The other credit allowed against the tentative tax is computed by taking 16½ percent of the credit for dividends received as described in section 26 (b), relating to dividends received from domestic corporations.

The application of the general rule set out in subsection (c) of section 13 may be illustrated by the following example:

Example: The A Corporation, a domestic corporation, which is not a bank affiliate referred to in section 26 (d), has for the calendar year 1938 a net income of $110,000, including interest on United States obligations in the amount of $10,000 allowable as a credit under section 26 (a) and dividends amounting to $10,000 from domestic corporations subject to taxation under Title I. The corporation pays to its shareholders, during the taxable year, $30,000 in dividends. It is not entitled to any dividend carry-over under section 27. Its tax for the calendar year 1938 is $17,097.50, computed as follows:

Computation of Tax

Tentative tax:			
Net income	$110,000		
Less credit for interest on United States obligations	10,000		
Adjusted net income	100,000		
Tentative tax under section 13 (c) (19 percent of $100,000)			$19,000.00
Credits on account of dividends received and dividends paid:			
(1) Dividends received (85 percent of $10,000 × 16½ percent)		$1,402.50	
(2) Dividends paid ($30,000 − $10,000 × 2½ percent)		500.00	
Total credit (section 13 (c) (2))			1,902.50
Total tax			17,097.50

ART. 13-3. *Alternative tax (corporations with net incomes slightly more than $25,000).*—Subsection (d) of section 13 provides an alternative method for computing the tax in the case of corporations having net incomes of slightly more than $25,000. If no portion of the gross income consists of interest on obligations of the United States and its instrumentalities allowable as a

credit under section 26 (a), or of dividends of the class with respect to which the credit is allowable under section 26 (b), the alternative tax is equal to $3,525 plus 32 percent of the amount of the net income in excess of $25,000. If any portion of the gross-income consists of interest or dividends referred to in the preceding sentence, it is necessary, in order to determine the amount of net income subject to tax and the rate of tax applicable thereto, first to divide the income into two parts, or divisions, the first division consisting of $25,000 and the second division consisting of the balance of the net income in excess of $25,000.

The first division is composed, first, of gross income from interest on obligations of the United States and its instrumentalities, allowable as a credit under section 26 (a); second, the portion of the gross income consisting of dividends of the class with respect to which credit is allowable under section 26 (b); and, third, an amount equal to the excess, if any, of $25,000 over the sum of the gross income from interest on such obligations and dividends as are already allocated to the first division. For the purposes of section 13, this excess is referred to in these regulations as "ordinary income." In segregating the portion of the net income allocated to the second division, the portion of the gross income from interest on certain obligations of the United States and its instrumentalities, credit for which is allowable under section 26 (a), which has not already been allocated to the first division is allocated to the second division. Gross income from dividends of the class with respect to which credit is allowable under section 26 (b), not already allocated to the first division, is next assigned as a portion of the net income in the second division. The excess, if any, of the portion assigned to the second division over the sum of the gross income from such interest and dividends, allocated to the second division, is considered to be ordinary income for the purposes of section 13. The alternative tax in such a case is the sum of three items: First a tax is computed under section 14 (c) on the $25,000 as allocated to the first division, as if this amount constituted the entire net income of the corporation. To this tax there is added 12 percent of the dividends allocated to the second division and 32 percent of the amount of the ordinary income allocated to the second division. The following examples illustrate the computation of the alternative tax in such a case, and demonstrate that in some cases the tax imposed under the general rule will be less than the alternative tax, while in other cases the alternative tax will be less than the tax imposed under the general rule:

Example (1): The A Corporation, a domestic corporation (not a bank affiliate), has for the calendar year 1938 a net income of $34,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $15,000 and dividends amounting to $12,000 (allowable as a credit under section 26 (b)). It is not entitled to a dividends paid credit under section 27. Since, as will hereinafter appear, the alternative tax is more than the tax computed under the general rule, the correct tax is the tax computed under the general rule, that is, $1,937. The tax is computed as follows:

Tax Under General Rule

Net income	$34,000.00
Less interest on United States obligations	15,000.00
Adjusted net income	19,000.00
Tentative tax (19 percent of $19,000.00)	3,610.00
Less credit for dividends received (16½ percent of 85 percent of $12,000.00)	1,683.00
Total tax under general rule	1,927.00

Alternative Tax

Total net income	$34,000.00
Less net income allocated to first division	25,000.00
Net income allocated to second division	9,000.00
Tax on first division:	
Total net income	25,000.00
Less interest on United States obligations	15,000.00
Adjusted net income	10,000.00
Less credit for dividends received (85 percent of $10,000)	8,500.00
Special class net income (section 14 (a))	1,500.00
Tax under section 14 (12½ percent of $1,500)	187.50
Tax on second division:	
Total income allocated to second division	9,000.00
Less dividends received allocated to second division	2,000.00
Ordinary income	7,000.00
Tax:	
(12 percent of $2,000)	240.00
(32 percent of $7,000)	2,240.00
Total tax on second division	2,480.00
Total alternative tax:	
Tax on first division	187.50
Tax on second division	2,480.00
Total alternative tax	2,667.50

Example (2): The A Corporation, a domestic corporation (not a bank affiliate), has for the calendar year 1938 a net income of $27,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $10,000, but no dividends allowable as a credit under section 26 (b). It paid dividends during the year in the amount of $15,000. It is not entitled to any dividend carry-over under section 27. Since the alternative tax is less than the tax computed under the general rule, the correct tax is the alternative tax, that is, $2,665. The tax is computed as follows:

Alternative Tax

Allocation of income:	
First division:	
Interest on United States obligations	$10,000
Ordinary income	15,000
Total	25,000
Second division:	
Ordinary income	2,000
Total income	27,000
Tax under alternative plan:	
First division:	
12½ percent of $5,000	625
14 percent of $10,000	1,400
Total tax on first division	2,025
Tax on second division (32 percent of $2,000)	640
Total tax under alternative plan	2,665

Tax Under General Rule

Total net income	$27,000
Less interest on United States obligations	10,000
Adjusted net income	17,000
Tentative tax (19 percent of $17,000)	3,230
Less credit for dividends paid (2½ percent of $15,000—$10,000)	125
Tax	3,105

ART. 13-4. *Corporations in bankruptcy or receivership, joint-stock land banks and rental housing corporations.*—In any case in which the tax is computed under subsection (c) of section 13 and the taxpayer is—

(1) a domestic corporation which for any portion of the taxable year is in bankruptcy under the laws of the United States, or insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia, or

(2) a joint-stock land bank organized under the Federal Farm Loan Act, as amended, or

(3) a corporation which at the close of the taxable year is regulated or restricted by the Federal Housing Administrator under section 207 (b) (2) of the National Housing Act, as amended, and such administrator certifies to the Commissioner the fact that such regulation or restriction existed at the close of the taxable year,

then in lieu of the credit against the tentative tax as computed under subsection (c) on account of dividends paid, there shall be allowed a credit of 2½ percent of the adjusted net income. If the net income of any such corporation is $25,000 or less, it is taxed under section 14, and if its net income is slightly more than $25,000, it may be subject to the alternative tax under section 13 (d).

Generally, in the case of any proceedings under the Bankruptcy Act of 1898, as amended, the corporation is in bankruptcy if it has been adjudicated bankrupt, if a petition for reorganization of the corporation has been filed by the corporation or its creditors and has been approved by the court having jurisdiction thereof, or if the corporation has filed a petition for an arrangement of its indebtedness under Chapter XI of the Act in a court having jurisdiction thereof. In such case, the provisions of subsection (e) of section 13, allowing a credit of 2½ percent of the adjusted net income, in lieu of the credit on account of dividends paid, shall not apply to—

(*a*) the debtor corporation if the proceeding is dismissed prior to the confirmation by the court of a plan of reorganization or an arrangement;

(*b*) any corporation organized pursuant to the provisions of the plan;

(*c*) any corporation which pursuant to the plan or arrangement acquires any of the properties of the debtor corporation by way of consolidation or merger or any corporation which is merged or consolidated with the debtor corporation pursuant to the plan; or

(*d*) the debtor corporation for any taxable year subsequent to the taxable year during which any of the properties dealt with by the plan either

(1) are transferred and conveyed by the trustee or trustees to the debtor corporation or the other corporation or corporations provided for by the plan, or,

(2) if no trustee has been appointed, are retained by the debtor corporation,

free and clear of all claims of the debtor corporation, its shareholders and creditors, except such claims as may consistently with the plan be reserved in the order confirming the plan or directing the transfer and conveyance or retention of such properties.

The term "insolvent" means insolvency in the sense of excess of liabilities over assets and in the sense of inability to meet obligations as they mature.

Any corporation claiming the credit under subsection (e), (f), or (g) of section 13, that is, seeking to reduce the tentative tax by 2½ percent of the adjusted net income, instead of by 2½ percent of the dividends paid credit, shall file as a part of its return for each taxable year for which such credit is claimed a statement under oath of all facts pertinent to its claim.

SEC. 14. *Tax on special classes of corporations.*—(*a*) *Special class net income.*—For the purposes of this title the term "special class net income" means the adjusted net income minus the credit for dividends received provided in section 26 (b).

(*b*) There shall be levied, collected, and paid for each taxable year upon the special class net income of the following corporations (in lieu of the tax imposed by section 13) the tax hereinafter in this section specified.

(*c*) *Corporations with net incomes of not more than $25,000.*—If the net income of the corporation is not more than $25,000, and if the corporation does not come within one of the classes specified in subsection (d), (e), (f), or (g) of this section, the tax shall be as follows:

Upon special class net incomes not in excess of $5,000, 12½ per centum.

$625 upon special class net incomes of $5,000, and upon special class net incomes in excess of $5,000 and not in excess of $20,000, 14 per centum in addition of such excess.

$2,725 upon special class net incomes of $20,000, and upon special class net incomes in excess of $20,000, 16 per centum in addition of such excess.

(*d*) *Special classes of corporations.*—In the case of the following corporations the tax shall be an amount equal to 16½ per centum of the special class net income, regardless of the amount thereof:

(1) Banks, as defined in section 104.

(2) Corporations organized under the China Trade Act, 1922.

(3) Corporations which, by reason of deriving a large portion of their gross income from sources within a possession of the United States, are entitled to the benefits of section 251.

(*e*) *Foreign corporations.*—(1) In the case of a foreign corporation engaged in trade or business within the United States or having an office or place of business therein, the tax shall be an amount equal to 19 per centum of the special class net income, regardless of the amount thereof.

(2) In the case of a foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein, the tax shall be as provided in section 231 (a).

(*f*) *Insurance companies.*—In the case of insurance companies, the tax shall be as provided in Supplement G.

(*g*) *Mutual investment companies.*—In the case of mutual investment companies, as defined in Supplement Q, the tax shall be as provided in such Supplement.

(*h*) *Exempt corporations.*—For corporations exempt from taxation under this title, see section 101.

(*i*) *Tax on personal holding companies.*—For surtax on personal holding companies, see Title IA.

(*j*) *Improper accumulation of surplus.*—For surtax on corporations which accumulate surplus to avoid surtax on shareholders, see section 102.

ART. 14-1. *Tax on special corporations.*—Section 14 imposes an income tax upon (1) corporations having net incomes of not more than $25,000, (2) certain special classes of corporations, and (3) certain foreign corporations. The special classes of corporations are banks, as defined in section 104, corporations organized under the China Trade Act, 1922, and corporations which, by reason of deriving a large portion of their gross income from sources within a possession of the United States, are entitled to the benefits of section 251. The tax imposed by section 14 is in lieu of the tax imposed by section 13. Corporations expressly exempt from taxation under Title I (see section 101) are not subject to tax under section 14.

The tax is imposed upon the "special class net income," that is, the adjusted net income minus the credit for dividends received provided in section 26 (b), relating to dividends received from a domestic corporation which is subject to taxation under Title I (85 percent of dividends received, but not in excess of 85 percent of the adjusted net income). The term "special class net income" is used elsewhere in the regulations under Title I and where so used has the meaning here given it.

As in the case of corporations subject to the tax under section 13, it makes no difference that a domestic corporation subject to any tax imposed by section 14 may derive no income from sources within the United States. So also, the tax is payable upon the basis of returns rendered by the corporations liable thereto, except that in some cases a tax is to be paid at the source of the income (see also sections 47, 52, 53, 144, and 235). For what the term "corporation" includes and for the difference between domestic and foreign corporations, see section 901. For surtax on personal holding companies, see Title IA. For surtax on corporations improperly accumulating surplus, see section 102. For the duration of the operation of section 14, see section 15.

Example: The A Corporation, a domestic corporation, has for the calendar year 1938 a net income of $24,000, including interest on United States obligations (allowable as a credit under section 26 (a)), in the amount of $9,000 and dividends received of the class allowable as a credit under section 26 (b) in the amount of $5,000. The corporation pays to its shareholders, during the taxable year, $5,000 in dividends. The tax upon the corporation is $1,430, computed as follows:

Total net income	$24,000
Less interest on United States obligations	9,000
Adjusted net income	15,000
Deduct credit under section 26 (b) (85 percent of $5,000)	4,250
Special class net income	10,750
Tax on $5,000 from table on p. 623	625
Tax on $5,750 at 14 percent	805
Total tax	1,430

Subsection (d) of section 14 relates to (1) banks, as defined in section 104, (2) corporations organized under the China Trade Act, 1922, and (3) corporations which, by reason of deriving a large portion of their gross income from sources within possessions of the United States, are entitled to the benefits of section 251. That subsection imposes an income tax upon such corporations in an amount equal to 16½ percent of the special class net income, regardless of the amount thereof.

Subsection (e) of section 14 provides for a tax on foreign corporations engaged in trade or business within the United States or having an office or place of business therein, equal to 19 percent of the special class net income, regardless of the amount thereof. In the case of foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, the tax is as provided in section 231 (a). In the case of insurance companies, the tax is as provided in Supplement G. In the case of mutual investment companies, as defined in Supplement Q, the tax is as provided in Supplement Q.

Subsection (c) of section 14 imposes a tax at graduated rates on corporations which do not have net incomes of more than $25,000 and which do not come within one of the classes specified in subsection (d) (special classes of corporations), (e) (foreign corporations), (f) (insurance companies), or (g) (mutual investment companies) of section 14. The tax is the same whether or not the corporation distributes any dividends during the taxable year.

The following table shows the income tax due from corporations coming within the terms of subsection (c) of section 14 upon certain specified amounts of special class net income. In each instance the first figure of the special class net income in the special class net-income column is to be excluded and the second figure included. The percentage given opposite applies to the excess of income over the first figure in the special class net-income column. The last column gives the total tax on a special class net income equal to the second figure in the special class net-income column:

Table of Corporation Income Tax Under Section 14 (c)

Special class net income	Percent	Total tax
$0 to $5,000	12½	$625
$5,000 to $20,000	14	2,725
$20,000 to $25,000	16	3,525

The tax under subsection (c) of section 14 for any amount of special class net income not shown in the table is computed by adding to the tax for the largest amount shown which is less than the special class net income, the tax upon the excess over that amount at the rate indicated in the table.

SEC. 15. *Corporate taxes effective for two taxable years.*—The taxes imposed by section 13, section 14 (except subsection (e) (2)), Supplement G, or Supplement Q, of this Act, or by section 13, section 14, or Supplement G of the Revenue Act of 1936, shall not apply to any taxable year beginning after December 31, 1939.

CHAPTER III

Gross Income—Net Income

Part II—Computation of Net Income

SEC. 21. *Net income.*—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23. For definition of "adjusted net income", see section 13 (a); for definition of "special class net income", see section 14 (a).

ART. 21-1. *Meaning of net income.*—The tax imposed by Title I is upon income. Neither income exempted by statute or fundamental law, nor expenses incurred in connection therewith, other than interest, enter into the computation of net income as defined by section 21. (See section 24 (a) (5).) In the computation of the tax various classes of income must be considered:

(*a*) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets. Cash receipts alone do not always accurately reflect income, for the Act recognizes as income-determining factors other items, among which are inventories, accounts receivable, property exhaustion, and accounts payable for expenses incurred. (See sections 22, 23, 24, and 117.)

(*b*) Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by the Act. (See section 22.)

(*c*) Net income, meaning gross income less statutory deductions. The statutory deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income. (See sections 23 and 24.)

(*d*) Net income less credits. (See sections 25, 26, 27, and 28.)

The normal taxes and surtaxes imposed on individuals and on corporations are computed upon net income less certain credits. Although taxable net income is a statutory conception, it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory net income is commercial net income. This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer. (See section 41.)

The net income of corporations is determined in general in the same manner as the net income of individuals, but the deductions allowed corporations are not precisely the same as those allowed individuals. (See sections 23, 24, 102, 118, 121, 203, 204, 207, 232, 336, and Title IA.)

SEC. 22. *Gross income.*—(*a*) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

ART. 22 (a)-1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211-238 and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or of property.

If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. This paragraph does not apply, however, to the issuance by a corporation to its shareholders of the right to subscribe to its stock, as to which see article 22 (a)-8.

The fact that a dividend is declared shortly after the sale of corporate stock and the sale price is influenced by the expectation of the payment of a dividend, does not make such dividend when paid taxable to the vendor as a dividend. The amount advanced by the vendee to the vendor in contemplation of the next dividend payment is an investment of capital and may not be claimed as a deduction from gross income. As to the amount of income tax paid for a bondholder by the obligor pursuant to a so-called tax-free covenant, see section 143 (a) (3). As to the determination of gain or loss from the sale or other disposition of property, see sections 111-113.

As to insurance companies and foreign corporations, see sections 202, 204, 206, 207, and 231.

ART. 22 (a)-2. *Compensation for personal services.*—Commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, pay of persons in the military or naval forces of the United States, retired pay of Federal and other officers, and pensions or retiring allowances paid by private persons or by the United States are income to the recipients; as are also marriage fees, baptismal offerings, sums paid for saying masses for the dead, and other contributions received by a clergyman, evangelist, or religious worker for services rendered. However, so-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable. The salaries of Federal officers and employees are subject to tax. See article 116-2 as to compensation of State officers and employees.

ART. 22 (a)-3. *Compensation paid other than in cash.*—If services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included as income. If the services were rendered at a stipulated price, in the absence of evidence to the contrary such price will be presumed to be the fair value of the compensation received. If a corporation transfers to its employees its own stock as compensation for services rendered by the employee, the amount of such compensation to be included in the gross income of the employee is the fair market value of the stock at the time of the transfer. If living quarters such as camps are furnished to employees for the convenience of the employer, the ratable value need not be added to the cash compensation of the employees, but if a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to such person of the quarters furnished constitutes income subject to tax. The value of quarters furnished to the commissioned officers, chief warrant officers, warrant officers, and enlisted personnel of the Army, Navy, Coast Guard, Coast and Geodetic Survey, and Public Health Service, or amounts received by them as commutation of quarters, are to be excluded from gross income. (See also section 22 (b) (6).) Premiums paid by an employer on policies of group life insurance covering the lives of his employees, the beneficiaries of which are designated by the employees, are not income to the employees. (See article 24-3.)

ART. 22 (a)-4. *Compensation paid in notes.*—Notes or other evidences of indebtedness received in payment for services constitute income to the amount of their fair market value. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt the fair discounted value of the note at such time. Thus, if it appears that such a note is or could be discounted on a 6 percent basis, the recipient shall include such note in his gross income to the amount of its face value less discount computed at the prevailing rate for such transactions. If the payments due on a note so accounted for are met as they become due, there should be included as income in respect of each such payment so much thereof as represents recovery for the discount originally deducted.

ART. 22 (a)-5. *Gross income from business.*—In the case of a manufacturing, merchandising, or mining business "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold. But see article 23 (m)-1 (*g*).

ART. 22 (a)-6. *State contracts.*—The profit from a contract with a State or political subdivision thereof must be included in gross income. If warrants are issued by a city, town, or other political subdivision of a State, and are accepted by the contractor in payment for public work done, the fair market value of such warrants should be returned as income. If for any reason the contractor upon conversion of the warrants into cash does not receive and cannot recover the full value of the warrants so returned, he may deduct from gross income for the year in which the warrants are converted into cash any loss sustained, and if he realizes more than the value of the warrants so returned he should include the excess in his gross income for the year in which realized.

ART. 22 (a)-7. *Gross income of farmers.*—A farmer reporting on the basis of receipts and disbursements (in which no inventory to determine profits is used) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received during the taxable year from the sale of live stock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any live stock or other items which were purchased, and (3) gross income from all other sources. The profit from the sale of live stock or other items which were purchased after February 28, 1913, is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of animals purchased as draft or work animals or solely for breeding or dairy purposes and not for resale, the profit shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation theretofore allowed (but not less than the amount allowable) in respect of such property as a deduction in computing net income.

In the case of a farmer reporting on the accrual basis (in which an inventory is used to determine profits), his gross profits are ascertained by adding to the inventory value of live stock and products on hand at the end of the year the amount received from the sale of live stock and products, and miscellaneous receipts for hire of teams, machinery, and the like, during the year, and deducting from this sum the inventory value of live stock and products on hand at the beginning of the year and the cost of live stock and products purchased during the year. In such cases all live stock raised or purchased for sale shall be included in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Also live stock acquired, for draft, breeding, or dairy purposes and not for sale, may be included in the inventory, instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently by the taxpayer. In case of the sale of any live stock included in an inventory their cost must not be taken as an additional deduction in the return of income, as such deduction will be reflected in the inventory. (See article 22 (c)-6.)

In every case of the sale of machinery, farm equipment, or other capital assets purchased after February 28, 1913 (which are not to be included in an inventory if one is used to determine profits), any excess over the cost thereof less the amount of depreciation theretofore allowed (but not less than the amount allowable) in respect of such property as a deduction in computing net income, shall be included as gross income. If farm produce is exchanged for merchandise, groceries, or the like, the market value of the article received in exchange is to be included in gross income. Rents received in crop shares shall be returned as of the year in which the crop shares are reduced to money or the equivalent of money. Proceeds of insurance, such as hail and fire insurance on growing crops, should be included in gross income to the amount received in cash or its equivalent for the crop injured or destroyed. If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may, with the consent of the Commissioner (see article 41-2), be computed upon the crop basis; but in any such cases the entire cost of producing the crop must be taken as a deduction for the year in which the gross income from the crop is realized.

As herein used the term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms; also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers. A person cultivating or operating a farm for recreation or pleasure, the result of which is a continual loss from year to year, is not regarded as a farmer.

Form 1040F should be filled in and attached to his income tax return by every farmer who either keeps no records or only records of cash receipts and disbursements; its use is optional with other farmers. (See further articles 23 (a)-11, 23 (e)-5, and 23 (l)-10.)

ART. 22 (a)-8. *Sale of stock and rights.*—If shares of stock in a corporation are sold from lots purchased at different dates or at different prices and the identity of the lots can not be determined, the stock sold shall be charged against the earliest purchases of such stock. In the determination of the earliest purchases of stock the rules prescribed in paragraphs (1), (2), (3), and (4) of section 117 (h) (relating to the period for which property has been held) shall be applied. The excess of the amount realized on the sale over the cost or other basis of the stock will constitute gain. In the case of stock in respect of which was paid a stock dividend which did not constitute income under the Constitution, the basis for determining gain or loss from a sale of either the stock in respect of which the distribution was made or the stock dividend shall be ascertained in accordance with the principles set forth in article 113 (a) (12)-1. If common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price shall be fairly apportioned between such common stock and the securities purchased for the purpose of determining the portion of the cost attributable to each class of stock or securities, but if that should be impracticable in any case, no profit on any subsequent sale of any part of the stock or securities will be realized until out of the proceeds of sales shall have been recovered the total cost.

Although the issuance by a corporation to its shareholders of rights to subscribe to its stock may not under section 115 (f) give rise to taxable income, gain may be derived or loss sustained by the shareholder from the sale of such rights. In the case of stock in respect of which were issued stock subscription rights which did not constitute income under the Constitution, and in the case of such rights, the following rules are to be applied:

(1) If the shareholder does not exercise, but sells, his rights to subscribe, the cost or other basis of the stock in respect of which the rights are issued shall be apportioned between the rights and the stock in proportion to the respective values thereof at the time the rights are issued, and the basis for determining gain or loss from the sale of a right on one hand or a share of stock on the other will be the quotient of the cost or other basis assigned to the rights or the stock, divided, as the case may be, by the number of rights issued or by the number of shares held.

Example: A taxpayer in 1933 purchased 500 shares of common stock at $125 a share, and in 1938, by reason of the ownership of such stock, received 500 rights entitling him to subscribe to 100 additional shares of such stock at $100 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were issued had a fair market value of $120, and the rights had a fair market value of $3 each. Instead of subscribing to the additional shares, he sold the rights at $4 each. The profit is computed as follows:

500 (shares) × $125	=$62,500,	cost of old stock (stock in respect of which the rights were issued)
500 (shares) × $120	=$60,000,	market value of old stock
500 (rights) × $3	=$1,500,	market value of rights
$\frac{60,000}{61,500}$ of $62,500	=$60,975.61,	cost of old stock apportioned to such stock after issuance of rights
$\frac{1,500}{61,500}$ of $62,500	=$1,524.39,	cost of old stock apportioned to rights

$2,000 (proceeds of sale of rights) less $1,524.39 (cost of old stock apportioned to rights) =$475.61, profit.

For the purpose of determining the gain or loss from the subsequent sale of the stock in respect of which the rights were issued, the adjusted cost of each share is $121.95—that is, $60,975.61÷500.

(2) If the shareholder exercises his rights to subscribe, the basis for determining gain or loss from a subsequent sale of a share of the stock in respect of which the rights were issued shall be determined as in paragraph (1). The basis for determining gain or loss from a subsequent sale of a share of the stock obtained through exercising the rights shall be determined by dividing the part of the cost or other basis of the old shares assigned to the rights, plus the subscription price of the new shares, by the number of new shares obtained.

Example: A taxpayer in 1935 purchased 500 shares of common stock at $125 a share, and in 1938, by reason of the ownership of such stock, received 500 rights entitling him to subscribe to 100 additional shares of such stock at $100 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were issued had a fair market value of $120, and the rights had a fair market value of $3 each. The taxpayer exercised his rights to subscribe to the additional shares and later sold one of such shares for $140. The profit is computed as follows:

$1,524.39 (cost of old stock apportioned to rights pursuant to the computation in the example under paragraph (1)) +$10,000 (subscription price of additional shares) =$11,524.39, basis for determining gain or loss from sale of additional shares.

$11,524.39÷100=$115.24, basis for determining gain or loss from sale of each share of additional stock.

$140 (proceeds of sale of share of additional stock) less $115.24=$24.76, profit.

The basis for determining the gain or loss from subsequent sale of the stock in respect of which the rights were issued is $60,975.61÷500, or $121.95 a share.

If the stock in respect of which the rights are issued was purchased at different times or at different prices and the identity of the lots cannot be determined, or if the stock in respect of which the rights are issued was purchased at different times or at different prices and the stock rights issued in respect of such stock cannot be identified as having been issued in respect of any particular lot of such stock, the basis for determining the gain or loss from the sale of the old shares, or the rights in cases where the rights are sold, or from the sale of the old or new shares in cases where the rights are exercised, shall be ascertained in accordance with the principles laid down in article 113 (a) (12)-1.

If a stock right is distributed tax free under section 115 (f), the taxpayer may at his option include the entire proceeds from the sale of nontaxable stock rights in gross income, in which case the basis for determining gain or loss from the subsequent sale of the stock in respect of which the rights were issued shall be the same as though the rights had not been issued.

As to deductions for losses from sales or exchanges of stocks or bonds, including losses from sales or exchanges of rights to subscribe to stock, see article 23 (e)-1.

ART. 22 (a)-9. *Sale of patents and copyrights.*—A taxpayer disposing of patents or copyrights by sale should determine the gain or loss arising therefrom by computing the difference between the selling price and the cost or other basis, with proper adjustment for depreciation, as provided in articles 111-1, 113 (a) (14)-1, 113 (b)-1, and 113 (b)-2.

ART. 22 (a)-10. *Sale of good will.*—Gain or loss from a sale of good will results only when the business, or a part of it, to which the good will attaches is sold, in which case the gain or loss will be determined by comparing the sale price with the cost or other basis of the assets, including good will. (See *articles 111-1, 113 (a) (14)-1, 113 (b)-1,* 113 (b)-2, and 113 (b)-3.) If specific payment was not made for good will there can be no deductible loss with respect thereto, but gain may be realized from the sale of good will built up through expenditures which have been currently deducted. It is immaterial that good will may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost or other basis of the good will sold.

ART. 22 (a)-11. *Sale of real property in lots.*—If a tract of land is purchased with a view to dividing it into lots or parcels of ground to be sold as such, the cost or other basis shall be equitably apportioned to the several lots or parcels and made a matter of record on the books of the taxpayer, to the end that any gain derived from the sale of any such lots or parcels which constitutes taxable income may be returned as income for the year in which the sale is made. This rule contemplates that there will be gain or loss on every lot or parcel sold, and not that the capital in the entire tract may be recovered before any taxable income shall be returned. The sale of each lot or parcel will be treated as a separate transaction, and gain or loss computed accordingly.

ART. 22 (a)-12. *Annuities and insurance policies.*—Annuities paid by religious, charitable, and educational corporations under an annuity contract are, in general, subject to tax to the same extent as annuities from other sources paid under similar contracts. (See section 22 (b) (2) and article 22 (b) (2)-2.) An annuity charged upon devised land is taxable to a donee-annuitant if payable only out of the rents or other income of the land. In such case the devisee is not required to return as gross income the amount of rent or other income paid to the annuitant, and he is not entitled to deduct from his gross income any sums paid to the annuitant. Amounts received as a return of premiums paid under life insurance, endowment, or annuity contracts, and the so-called "dividend" of a mutual insurance company which may be credited against the current premium, are not subject to tax.

ART. 22 (a)-13. *Improvements by lessees.*—If buildings are erected or improvements made by a lessee and such buildings or improvements immediately become the property of the lessor, as, for instance, if they are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon any one of the following bases:

(*a*) The lessor may report as income for the taxable year in which such buildings or improvements are completed their fair market value at the time of their completion.

(*b*) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(*c*) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

Except in cases where the lessor has reported income upon basis (*a*), if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor shall report income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he becomes entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the termination of the lease shall be included.

If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less proper adjustment for depreciation in case option (*a*) was exercised, and less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise. (See sections 23 (e) and (f) and 113 (a) (14).)

ART. 22 (a)-14. *Cancellation of indebtedness.*—(*a*) *In general.*—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See article 22 (a)-18.) In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

(*b*) *Proceedings under Bankruptcy Act.*—Income is not realized by a taxpayer by virtue of the discharge, under section 14 of the Bankruptcy Act, as amended, of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of an agreement among his creditors not consummated under any provision of the Bankruptcy Act, as amended, if immediately thereafter the taxpayer's liabilities exceed the value of his assets. Furthermore, income is not realized in any case by a taxpayer in the case of a cancellation or reduction of his indebtedness under—

(1) a plan of corporate reorganization confirmed under either section 77B or Chapter X of the Bankruptcy Act, as amended;

(2) a composition agreement confirmed under either section 12 or 74 of the Bankruptcy Act, as amended;

(3) an "arrangement" or a "real property arrangement" confirmed under Chapter XI or XII, respectively, of the Bankruptcy Act, as amended; or

(4) a "wage earner's plan" confirmed under Chapter XIII of the Bankruptcy Act, as amended.

If, however, such plan of corporate reorganization or agreement of composition referred to in (1) to (4) above had for one of its principal purposes the avoidance of income tax, the cancellation or reduction of indebtedness, under such plan or agreement confirmed under section 12, 74, or 77B or under Chapter X, XI, XII, or XIII of the Bankruptcy Act, as amended, may result in the realization of income. (See page 665 of the Appendix to these regulations.)

For adjustment of basis of certain property in the case of cancellation or reduction of indebtedness required by the Bankruptcy Act, as amended by the Act of June 22, 1938 (Public, No. 696, Seventy-fifth Congress), see article 113 (b)-2.

ART. 22 (a)-15. *Creation of sinking fund by corporation.*—If a corporation, in order solely to secure the payment of its bonds or other indebtedness, places property in trust or sets aside certain amounts in a sinking fund under the control of a trustee who may be authorized to invest and reinvest such sums from time to time, the property or fund thus set aside by the corporation and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation and shall be included as such in its gross income.

ART. 22 (a)-16. *Acquisition or disposition by a corporation of its own capital stock.*—Whether the aquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.

But if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Act.

ART. 22 (a)-17. *Contributions to corporation by shareholders.*—If a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments under such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. (See articles 22 (a)-14 and 24-2.)

ART. 22 (a)-18. *Sale and purchase by corporation of its bonds.*—(1) (*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (*b*) If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. (*c*) If, however, the corporation purchases any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

(2) (*a*) If, subsequent to February 28, 1913, bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. (*b*) If the corporation purchases any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. (*c*) If, however, the corporation purchases any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price, minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned as income), over the purchase price is gain or income for the taxable year.

(3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. (*b*) If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. (*c*) If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is gain or income for the taxable year.

(4) (*a*) If bonds were issued by a corporation prior to March 1, 1913, at a premium, the net amount of such premium was gain or income for the year in which the bonds were issued and should not be prorated or amortized over the life of the bonds. (*b*) If the corporation purchases any of such bonds at a price in excess of the face value of the bonds, the excess of the purchase price over the face value is a deductible expense for the taxable year. (*c*) If, however, the corporation purchases any of such bonds at a price less than the face value the excess of the face value over the purchase price is gain or income for the taxable year.

ART. 22 (a)-19. *Sale of capital assets by corporation.*—If property is acquired and later sold for an amount in excess of the cost or other basis, the gain on the sale is income. If, then, a corporation sells its capital assets in whole or in part, it shall include in its gross income for the year in which the sale was made the gain from such sale, computed as provided in sections 111-113. If the purchaser takes over all the assets and assumes the liabilities, the amount so assumed is part of the selling price.

ART. 22 (a)-20. *Income to lessor corporation from leased property.*—If a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness, together with taxes, insurance, or other fixed charges, such payments shall be considered rental payments and shall be returned by the lessor corporation as income, notwithstanding the fact that the dividends and interest are paid by the lessee directly to the shareholders and bondholders of the lessor. The fact that a corporation has conveyed or let its property and has parted with its management and control, or has ceased to engage in the business for which it was originally organized, will not relieve it from liability to the tax. While the payments made by the lessee directly to the bondholders or shareholders of the lessor are rentals as to both the lessee and lessor (rentals paid in one case and rentals received in the other), to the bondholders and the shareholders such amounts are interest and dividend payments received as from the lessor and as such shall be accounted for in their returns.

ART. 22 (a)-21. *Gross income of corporation in liquidation.*—When a corporation is dissolved, its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes. (See sections 274 and 298.) Any sales of property by them are to be treated as if made by the corporation for the purpose of ascertaining the gain or loss. No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition. But see section 44 (d) and article 44-5. (See further article 52-2.)

[SEC. 22. *Gross income.*]

(*b*) *Exclusions from gross income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:

ART. 22 (b)-1. *Exemptions—Exclusions from gross income.*—Certain items of income specified in section 22 (b) are exempt from tax and may be excluded from gross income. These items, however, are exempt only to the extent and in the amount specified. No other items are exempt from gross income except (1) those items of income which are, under the Constitution, not taxable by the Federal Government; (2) those items of income which are exempt from tax on income under the provisions of any Act of Congress not inconsistent with or repealed by the Act; (3) the income exempted under the provisions of section 116. Since the tax is imposed on net income, the exemption referred to above is not to be confused with the deductions allowed by section 23 and other provisions of the Act to be made from gross income in computing net income. As to other items not to be included in gross income, see sections 112 and 119 and Supplements G, H, I, and J.

[SEC. 22. *Gross income.*]

[(*b*) *Exclusions from gross income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:]

(1) *Life insurance.*—Amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or otherwise (but if such amounts are held by the insurer under an agreement to pay interest thereon, the interest payments shall be included in gross income);

ART. 22 (b) (1)-1. *Life insurance—Amounts paid by reason of the death of the insured.*—The proceeds of life insurance policies, paid by reason of the death of an insured to his estate or to any beneficiary (individual, partnership, or corporation, but not a transferee for valuable consideration), directly or in trust, are excluded from the gross income of the beneficiary. While it is immaterial whether the proceeds of a life insurance policy payable upon the death of the insured are paid to the beneficiary in a single sum or in installments, only the amount paid solely by reason of the death of the insured is exempted. The amount exempted is the amount payable had the insured or the beneficiary not elected to exercise an option to receive the proceeds of the policy or any part thereof at a latter date or dates. If the policy provides no option for payment upon the death of the insured, or provides only for payments in installments, there is exempted only the amount which the insurance company would have paid immediately after the death of the insured had the policy not provided for payment at a later date or dates. Any increment thereto is taxable. In any mode of settlement the portion of each distribution which is to be so included in gross income shall be determined as follows:

(*a*) *Proceeds held by the insurer.*—If the proceeds are held by the insurer under an agreement (whether with the insured or with a beneficiary) to distribute either the increment to such proceeds currently, or the proceeds and increment in equal installments until both are exhausted, there shall be included in gross income, the increment so paid to the beneficiary, or so credited to the fund in each year by the insurer.

(*b*) *Proceeds payable in installments for a fixed number of years.*—If the proceeds are payable in installments for a fixed number of years, the amount that would have been payable by the insurance company immediately upon the death of the insured (if payment at a later date had not been provided for) is to be divided by the total number of installments payable over the fixed number of years for which payment is to be made, and the quotient represents the portion of each installment to be excluded from gross income. The amount of each installment in excess of such excluded portion is to be included in gross income. For example, if, at the insured's death, $1,000 would have been payable in a single installment, but 10 equal annual payments are made in lieu thereof, the portion of the installment received during any taxable year to be excluded from gross income is $100 ($1,000 divided by 10). Any amount received as an installment in excess of $100 is to be included in gross income.

(*c*) *Proceeds payable in installments during the life of the beneficiary.*—If the proceeds are payable in installments during the life of the beneficiary the amount of each installment that is to be included in gross income will be determined as in paragraph (*b*) of this article, except that the number of years to be used in the specified computation will be determined by the life expectancy of the beneficiary, as calculated by the table of mortality used by the particular insurance company in determining the amount of the annuity.

(*d*) *Proceeds payable for a fixed number of years and for continued life.*—If the proceeds are payable in installments for a fixed number of years and for continued life, the amount of each installment that is to be included in gross income will be determined either as provided in paragraph (*b*) of this article if the fixed number of years for which payment is to be made exceeds the life expectancy of the beneficiary, as calculated by the table of mortality used by the particular insurance company in determining the amount of the annuity; or, as provided in paragraph (*c*) of this article if such life expectancy exceeds the specified fixed period.

If a mode of settlement has been in effect prior to the first taxable year which begins after December 31, 1933 (or after December 31, 1935, in the case of a mode of settlement described in paragraph (*d*) of this article), the entire amount received and excluded from gross income in such prior years shall be deducted from the proceeds payable upon the death of the insured; the remainder shall be divided by the number of installments unpaid at the beginning of such taxable year (whether over the remaining portion of the fixed period or over the life expectancy as of that date, depending on the mode of settlement adopted); and that quotient shall be the excludible portion of each installment. As soon as the aggregate of the amounts received and excluded from gross income under the methods of computation provided for in this article equals the amount of the proceeds payable upon the death of the insured, the entire amount received thereafter in each taxable year must be included in gross income.

[SEC. 22. *Gross income.*]

[(*b*) *Exclusions from gross income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:]

(2) *Annuities, etc.*—Amounts received (other than amounts paid by reason of the death of the insured and interest payments on such amounts and other than amounts received as annuities) under a life insurance or endowment contract, but if such amounts (when added to amounts received before the taxable year under such contract) exceed the aggregate premiums or consideration paid (whether or not paid during the taxable year) then the excess shall be included in gross income. Amounts received as an annuity under an annuity or endowment contract shall be included in gross income; except that there shall be excluded from gross income the excess of the amount received in the taxable year over an amount equal to 3 per centum of the aggregate premiums or consideration paid for such annuity (whether or not paid during such year), until the aggregate amount excluded from gross income under this title or prior income tax laws in respect of such annuity equals the aggregate premiums or consideration paid for such annuity. In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance, endowment, or annuity contract, or any interest therein, only the actual value of such consideration and the amount of the premiums and other sums subsequently paid by the transferee shall be exempt from taxation under paragraph (1) or this paragraph:

ART. 22 (b) (2)-1. *Life insurance—Endowment contracts—Amounts paid other than by reason of the death of the insured.*—Amounts received under a life insurance or endowment policy (other than amounts paid by reason of the death of the insured, interest payments on such amounts, and amounts received as annuities) are not taxable until the aggregate of the amounts so received (when added to the amounts received before the taxable year under such policy) exceeds the aggregate premiums or consideration paid, whether or not paid during the taxable year.

ART. 22 (b) (2)-2. *Annuities.*—Amounts received as an annuity under an annuity or endowment contract include amounts received in periodical installments, whether annually, semi-annually, quarterly, monthly, or otherwise, and whether for a fixed period, such as a term of years, or for an indefinite period, such as for life, or for life and a guaranteed fixed period, and which installments are payable or may be payable over a period longer than one year. Such portion of each installment payment of an annuity shall be included in gross income as is not in excess of 3 percent of the aggregate premiums or consideration paid for such annuity, whether or not paid during the taxable year, divided by 12 and multiplied by the number of months in respect of which the installment is paid. As soon as the aggregate of the amounts received and excluded from gross income equals the aggregate premiums or consideration paid for such annuity, the entire amount received thereafter in each taxable year must be included in gross income. The provisions of this article may be illustrated by the following examples:

Example (1): A bought in 1935, for $50,000 consideration, a life annuity, payable in annual installments of $5,000. For the calendar year 1938 he would be required to include in gross income $1,500 of the $5,000 received during that year (3 percent of $50,000), $3,500 being exempt. If A should live long enough to receive as exempt $50,000, then all amounts he receives thereafter under the annuity contract would be included in gross income.

Example (2): A bought an annuity on October 1, 1938, paying $100,000 as consideration therefor. The annuity amounts to $7,824 a year, payable in semiannual installments of $3,912, and on December 1, 1938, A received $1,304, the first payment under the contract being for a 2-month period. A shall include in his gross income for the calendar year 1938 the sum of $500, being 3 percent of $100,000 (the consideration paid) divided by 12 and multiplied by 2 (the number of months in respect of which the installment was paid).

Example (3): A bought an increasing annuity on August 1, 1938, paying $40,000 as consideration therefor. The annuity amounts to $1,000 a year for the first year, $2,000 a year for the second year, and $3,000 a year thereafter, payable in quarterly installments. A received the first quarterly installment on November 1, 1938, amounting to $250. A shall include in his gross income for the calendar year 1938 the sum of $250, being such portion of the installment as is not in excess of 3 percent of $40,000 (the consideration paid) divided by 12 and multiplied by 3 (the number of months in respect of which the installment was paid).

[SEC. 22. *Gross income.*]
[(b) *Exclusions from gross income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:]

(3) *Gifts, bequests, and devises.*—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income);

ART. 22 (b) (3)-1. *Gifts and bequests.*—Property received as a gift, or received under a will or under statutes of descent and distribution, is exempt from the income tax, although the income therefrom derived from investment, sale, or otherwise is not. An amount of principal paid under a marriage settlement is a gift. Neither alimony nor an allowance based on a separation agreement is taxable income. (See article 24-1.)

[SEC. 22. *Gross income.*]
[(b) *Exclusions from gross income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:]

(4) *Tax-free interest.*—Interest upon (A) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (B) obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States; or (C) the obligations of the United States or its possessions. Every person owning any of the obligations enumerated in clause (A), (B), or (C) shall, in the return required by this title, submit a statement showing the number and amount of such obligations owned by him and the income received therefrom, in such form and with such information as the Commissioner may require. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit) and in the case of obligations of a corporation organized under Act of Congress, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from the taxes imposed by this title;

ART. 22 (b) (4)-1. *Interest upon State obligations.*—Interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia is exempt from the income tax. Obligations issued by or on behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State or Territory or a political subdivision thereof. Special tax bills issued for special benefits to property, if such tax bills are legally collectible only from owners of the property benefited, are not the obligations of a State, Territory, or political subdivision. The term "political subdivision," within the meaning of the exemption, denotes any division of the State or Territory which is a municipal corporation, or to which has been delegated the right to exercise part of the sovereign power of the State or Territory. As thus defined, a political subdivision of a State or Territory may or may not, for the purpose of exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory.

ART. 22 (b) (4)-2. *Dividends and interest from Federal land banks, Federal intermediate credit banks, national farm-loan associations, banks for cooperatives, and production credit corporations and associations.*—Section 26 of the Federal Farm Loan Act of July 17, 1916 (39 Stat., 360), as amended by an Act approved March 4, 1923 (42 Stat., 1454), provides that Federal land banks, Federal intermediate credit banks, and national farm-loan associations, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, and that first mortgages executed to Federal land banks, Federal intermediate credit banks, or to joint stock land banks, and farm-loan bonds, and debentures issued by intermediate credit banks, with the income therefrom, shall be exempt from taxation. Accordingly, the income derived from dividends on stock of Federal land banks, Federal intermediate credit banks, and national farm-loan associations and from interest on promissory notes secured by such first mortgages, or from such farm-loan bonds or debentures, is not subject to the income tax. However, dividends on the stock of the central bank for cooperatives, the production credit corporations, production credit associations, and banks for cooperatives, organized under the provisions of the Farm Credit Act of 1933, constitute income to the recipients, subject to both normal tax and surtax. Dividends on share accounts of Federal savings and loan associations are exempt from the normal tax under the provisions of section 5 (h) of the Home Owners' Loan Act of 1933 (48 Stat., 133).

ART. 22 (b) (4)-3. *Dividends from Federal reserve banks.*—Section 7 of the Federal Reserve Act of December 23, 1913, provides that Federal reserve banks, including the capital stock and surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. This exemption attaches to and follows the income derived from dividends on stock of Federal reserve banks in the hands of the shareholders, so that the dividends received on the stock of Federal reserve banks are not subject to the income tax. Dividends paid by member banks, however, are treated like dividends of ordinary corporations.

ART. 22 (b) (4)-4. *Interest upon United States obligations.*—Although interest upon the obligations of the United States and its possessions and upon obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States, is generally exempt from tax, in the case of obligations issued by the United States after September 1, 1917, which include Treasury certificates of indebtedness, Treasury bonds, and Treasury notes, and in the case of obligations of a corporation organized under Act of Congress, the interest is exempt from tax only if and to the extent provided in the Acts authorizing the issue thereof as amended and supplemented.

Every person owning any of the obligations enumerated in clause (A), (B), or (C) of paragraph (4) of subsection 22 (b) shall submit in his income tax return a statement showing the number and amount of such obligations owned and the income received therefrom. For the purpose of such statement, in the case of Treasury bills issued after June 17, 1930, (1) the "amount of such obligations" is their par (maturity) value and (2) the "income received therefrom" is the net excess of the amount realized during the taxable year from the sale or other disposition of the bills over the cost or other basis thereof, a separate computation of discount being unnecessary.

The interest on Treasury certificates of indebtedness is entirely exempt from Federal income taxes. Interest upon Treasury notes is exempt only to the extent provided in the terms of the issue. Interest (discount at which issued) on Treasury bills and any gain from the sale or other disposition of such bills are also entirely exempt from Federal income taxes. With respect to the nondeductibility of losses from the sale or other disposition of such bills, see article 23 (e)-1.

The interest on Treasury bonds is exempt from Federal income taxes except surtaxes imposed upon the income or profits of individuals, partnerships, associations, or corporations.

Treasury bonds are entitled to a limited exemption from surtaxes imposed by the United States. Interest on an aggregate of not exceeding $5,000 principal amount of these obligations is exempt from the surtaxes imposed by the Act. Interest in excess of the interest on an aggregate of not exceeding $5,000 principal amount of such obligations is subject to surtax and must be included in gross income.

Interest credited to postal savings accounts upon moneys deposited in postal savings banks is wholly exempt from income tax.

ART. 22 (b) (4)-5. *Treasury bond exemption in the case of trusts or partnerships.*—(*a*) When the income of a trust is taxable to beneficiaries, as in the case of a trust the income of which is to be distributed to the beneficiaries currently, each beneficiary is entitled to exemption as if he owned directly a proportionate part of the Treasury bonds held in trust. When, on the other hand, income is taxable to the trustee, as in the case of a trust the income of which is accumulated for the benefit of unborn or unascertained persons, the trust, as the owner of the bonds held in trust, is entitled to the exemption on account of such ownership.

(*b*) As the income of a partnership is taxable to the individual partners, each partner is entitled to exemption as if he owned directly a proportionate part of the bonds held by the partnership.

ART. 22 (b) (4)-6. *Interest upon United States obligations in the case of nonresident aliens and certain foreign organizations.*—By virtue of section 4 of the Victory Liberty Loan Act of March 3, 1919, amending section 3 of the Fourth Liberty Bond Act of July 9, 1918, the interest received on and after March 3, 1919, on bonds, notes, and certificates of indebtedness of the United States while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership, or association, not engaged in business in the United States, is exempt from income taxes.

[SEC. 22. *Gross income.*]

[(*b*) *Exclusions from gross income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:]

(5) *Compensation for injuries or sickness.*—Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;

(6) *Ministers.*—The rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation;

(7) *Income exempt under treaty.*—Income of any kind, to the extent required by any treaty obligation of the United States;

(8) *Miscellaneous items.*—The following items, to the extent provided in section 116:

Earned income from sources without the United States;

Salaries of certain Territorial employees;

The income of foreign governments;

Income of States, municipalities, and other political subdivisions;

Receipts of shipowners' mutual protection and indemnity associations;

Dividends from China Trade Act corporations;

Compensation of employees of foreign governments.

(*c*) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

ART. 22 (c)-1. *Need of inventories.*—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment but should exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased, title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected.

ART. 22 (c)-2. *Valuation of inventories.*—Section 22 (c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The bases of valuation most commonly used by business concerns and which meet the requirements of section 22 (c) are (*a*) cost and (*b*) cost or market, whichever is lower. (For inventories by dealers in securities, see article 22 (c)-5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether basis (*a*) or (*b*) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

In respect of normal goods, whichever basis is adopted must be applied with reasonable consistency to the entire inventory. Taxpayers were given an option to adopt the basis of either (*a*) cost or (*b*) cost or market, whichever is lower, for their 1920 inventories. The basis properly adopted for that year or any subsequent year is controlling, and a change can now be made only after permission is secured from the Commissioner. Application for permission to change the basis of valuing inventories shall be made in writing and filed with the Commissioner as provided in article 41-2. Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired. But see section 22 (d) as to inventories in certain industries. Where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

Inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. The inventories of taxpayers on whatever basis taken will be subject to investigation by the Commissioner, and the taxpayer must satisfy the Commissioner of the correctness of the prices adopted.

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz:

(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(3) Omitting portions of the stock on hand.

(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

(5) Including stock in transit, either shipped to or from the taxpayer, the title to which is not vested in the taxpayer.

ART. 22 (c)-3. *Inventories at cost.*—Cost means:

(1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(2) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

(3) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (*a*) the cost of raw materials and supplies entering into or consumed in connection with the product, (*b*) expenditures for direct labor, (*c*) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

(4) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. Among such cases are (*a*) farmers and raisers of live stock (see article 22 (c)-6), (*b*) miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike (see article 22 (c)-7), and (*c*) retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see article 22 (c)-8).

ART. 22 (c)-4. *Inventories at cost or market, whichever is lower.*—Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—

(*a*) Of goods purchased and on hand, and

(*b*) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i. e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss, which goods must be inventoried at cost.

Where no open market exists or where quotations are nominal, due to stagnant market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

ART. 22 (c)-5. *Inventories by dealers in securities.*—A dealer in securities who in his books of account regularly inventories unsold securities on hand either—

(*a*) At cost;

(*b*) At cost or market, whichever is lower; or

(*c*) At market value,

may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another method be authorized by the Commissioner pursuant to a written application therefor filed with the Commissioner as provided in article 41-2. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this article, as regularly inventoryíng his securities at cost. For the purpose of this rule a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.

ART. 22 (c)-6. *Inventories of live stock raisers and other farmers.*—Farmers may change the basis of their returns from that of receipts and disbursements to that of an inventory basis provided adjustments are made in accordance with one of the two methods outlined in (1) and (2) below. It is optional with the taxpayer which method is used, but, having elected one method, the option so exercised will be binding upon the taxpayer, and he will be precluded from filing amended returns upon the basis of the other method.

(1) Opening and closing inventories shall be used for the year in which the change is made. There should be included in the opening inventory all farm products (including live stock) purchased or raised which were on hand at the date of the inventory, and there must be submitted with the return for the current taxable year an adjustment sheet for the preceding taxable year based on the inventory method, upon the amount of which adjustment the tax shall be assessed and paid (if any be due) at the rate of tax in effect for that year. Ordinarily an adjustment sheet for the preceding year will be sufficient, but if, in the opinion of the Commissioner, such adjustment is not sufficient clearly to reflect income, adjustments for earlier years may be accepted or required. If it is impossible to render complete inventories for the preceding year or years, the Commissioner will accept estimates which, in his opinion, substantially reflect the income on the inventory basis for such preceding year or years; but inventories must not include real estate, buildings, permanent improvements, or any other assets subject to depreciation.

(2) No adjustment sheets will be required, but the net income for the taxable year in which the change is made must be computed without deducting from the sum of the closing inventory and the sales and other receipts, the inventory of live stock, crops, and products at the beginning of the year; provided, however—

(*a*) That if any live stock, grain, or other property on hand at the beginning of the taxable year has been purchased and the cost thereof not charged to expense, only the difference between the cost and the selling price should be reported as income for the year in which sold;

(*b*) But if the cost of such property has been charged to expense for a previous year, the entire amount received must be reported as income for the year in which sold.

Because of the difficulty of ascertaining actual cost of live stock and other farm products, farmers who render their returns upon an inventory basis may value their inventories according to the "farm-price method," which provides for the valuation of inventories at market price less direct cost of disposition. If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in article 41-2. In such case the opening inventory for the taxable year in which the change is made should be brought in at the same value as the closing inventory for the preceding taxable year. If such valuation of the opening inventory for the taxable year in which the change is made results in an abnormally large income for that year, there may be submitted with the return for such taxable year an adjustment statement for the preceding year. This statement shall be based on the "farm-price method" of valuing inventories, upon the amount of which adjustments the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such preceding year. If an adjustment for the preceding year is not, in the opinion of the Commissioner, sufficient clearly to reflect income, adjustment sheets for prior years may be accepted or required.

If returns have been made in which the taxable net income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding year into argeement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

ART. 22 (c)-7. *Inventories of miners and manufacturers.*—A taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product, which in the aggregate will absorb the total cost of production, may, with the consent of the Commissioner, use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds of product. See section 22 (d) as to inventories of producers and processors of certain non-ferrous metals and of tanners.

ART. 22 (c)-8. *Inventories of retail merchants.*—Retail merchants who employ what is known as the "retail method" of pricing inventories may make their returns upon that basis, provided (1) that the use of such method is designated upon the return, (2) that accurate accounts are kept, and (3) that such method is consistently adhered to unless a change is authorized by the Commissioner as provided in article 41-2. Under this method the total of the retail selling prices of the goods on hand at the end of the year in each department or of each class of goods is reduced to approximate cost by deducting therefrom an amount which bears the same ratio to such total as—

(*a*) the total of the retail selling prices of goods included in the opening inventory plus the retail selling prices of the goods purchased during the year, with proper adjustment to such selling prices for all mark-ups and mark-downs,

less

(*b*) the cost of the goods included in the opening inventory plus the cost of the goods purchased during the year, bears to (*a*).

This amount should represent as accurately as may be the amounts added to the cost price of the goods to cover selling and other expenses of doing business and for the margin of profit.

A taxpayer maintaining more than one department in his store or dealing in classes of goods carrying different percentages of gross profit should not use a percentage of profit based upon an average of his entire business, but should compute and use in valuing his inventory the proper percentages for the respective departments or classes of goods.

[SEC. 22. *Gross income.*]—

(d) *Inventories in certain industries.*—(1) *Producers and processors of certain non-ferrous metals.*—A taxpayer shall be entitled to elect the method of taking inventories provided in paragraph (2) if his principal business is—

(A) Smelting non-ferrous ores or concentrates, or refining non-ferrous metals, or both; or

(B) Producing brass, copper products, or brass products, or any one or more of them, not further advanced than rods, sheets, tubes, bars, plates, or strips.

(2) *Inventories of raw materials.*—A taxpayer entitled to elect, and who has so elected, shall, in taking his inventory as of the close of any taxable year beginning after December 31, 1938, of raw materials which are—

(A) used in a business described in paragraph (1); and

(B) not yet included in goods in process or finished goods; and

(C) so intermingled that they cannot be identified with specific invoices;

treat such raw materials remaining on hand as being: First, those included in the inventory as of the beginning of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year, in the order of acquisition.

(3) *Tanners.*—A taxpayer whose principal business is tanning hides or skins, or both, shall be entitled to elect (with respect to any taxable year beginning after December 31, 1938) the method provided in paragraph (2) as to the raw materials (including those included in goods in process and in finished goods) in the business of tanning hides, or skins, or both, if so intermingled that they cannot be identified with specific invoices.

(4) *Inventories at cost.*—In the case of the application of the provisions of paragraph (2) or (3) all inventories of such materials shall be taken at cost, including the inventory as of the close of the preceding taxable year.

(5) *Election of method.*—The method provided in paragraph (2) or (3) shall not be applied unless the taxpayer, at or before the filing of his return for the preceding taxable year, has filed with the Commissioner his election to have it apply.

(6) *Regulations as to change.*—The change to such method shall be made in accordance with such regulations as to the Commissioner, with the approval of the Secretary, may prescribe as necessary to prevent the avoidance of tax.

(7) *Change to different method.*—An election made under this subsection shall be irrevocable and the method so elected shall be applied in all subsequent taxable years notwithstanding any change in the principal business of the taxpayer, unless with the approval of the Commissioner change to a different method is authorized, and then upon such terms and conditions and in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe.

ART. 22 (d)-1. *Inventories of tanners, and producers and processors of certain non-ferrous metals—(a) Elective method.*—The general rule is that goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently acquired which cannot be so identified. An exception to this general rule is provided for in section 22 (d), which permits certain specifically described taxpayers to elect to treat certain raw materials remaining on hand at the close of the taxable year as being: first, those included in the inventory as of the beginning of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year, in the order of acquisition. No item in an inventory of raw materials to which this method is applied shall be valued at market. All inventories of such raw materials (including the inventory as of the close of the preceding taxable year) shall be taken at cost. The opening inventory of such raw materials for the taxable year for which an election is made shall be brought in at the same cost as the closing inventory of such raw materials for the preceding taxable year.

A taxpayer shall be entitled to elect to have such method applied in taking his inventory as of the close of any taxable year beginning after December 31, 1938, if his principal business at the beginning of such taxable year (as shown by all transactions during the preceding taxable year and any other facts and circumstances relevant to the determination of the principal business) is—

(1) Smelting non-ferrous ores or concentrates, or refining non-ferrous metals, or both;

(2) Producing brass, copper products, or brass products, or any one or more of them, not further advanced than rods, sheets, tubes, bars, plates, or strips; or

(3) Tanning hides or skins, or both.

(*b*) *Restrictions upon use of method.*—Except in the case of a taxpayer whose principal business is tanning hides or skins, or both, if a taxpayer elects to have the method provided for in section 22 (d) applied, such method shall be applied in taking inventory of all raw materials used in (1) smelting non-ferrous ores or concentrates, or refining non-ferrous metals, or both, or (2) producing brass, copper products, or brass products, or any one or more of them, not further advanced than rods, sheets, tubes, bars, plates, or strips; and it shall be applied only in taking inventory of such raw materials. To illustrate, suppose the principal business of the M Corporation is refining non-ferrous metals and such corporation is also engaged in producing copper products. If the M Corporation elects to use the method provided for in section 22 (d), it shall use such method in taking inventory of (1) all raw materials used in refining non-ferrous metals and (2) all other raw materials which are of a kind used in producing copper products, not further advanced than rods, sheets, tubes, bars, plates, or strips, and which are used by it in producing copper products, even though the copper products produced by it are further advanced than rods, sheets, tubes, bars, plates, or strips. In the case of a taxpayer whose principal business is tanning hides or skins, or both, such method shall be applied only in taking inventory of raw materials used in the business of tanning hides, or skins, or both.

The method provided for in section 22 (d) is to be applied only to raw materials which are so intermingled that they cannot be identified with specific invoices. There is a further restriction that the method provided for in section 22 (d) shall be applied only to raw materials not yet included in goods in process or finished goods, but this restriction does not apply in the case of a taxpayer whose principal business is tanning hides or skins, or both. Each taxpayer to whom these restrictions are applicable shall maintain such accounting records as will enable him to comply with such restrictions. If the taxpayer's principal business is tanning hides or skins, or both, the method provided for in section 22 (d), if elected by the taxpayer, shall be applied to all raw materials (including those included in goods in process and in finished goods) used in the business of tanning hides or skins, or both, if such raw materials are so intermingled that they cannot be identified with specific invoices.

ART. 22 (d)-2. *Time and manner of making election.*—The method of taking inventory provided for in section 22 (d) shall not be applied, unless the taxpayer at or before the filing of his return for the taxable year preceding the taxable year as of the close of which the method is first to be applied, has filed with the Commissioner his election to have it applied. Such election shall be made under oath or affirmation on Form 970 in triplicate in accordance with the instructions printed thereon and with these regulations and shall be accompanied by a complete statement of all facts pertaining to the taxpayer's right to make such election, including—

1. A description of each business carried on by the taxpayer during the taxable year preceding the taxable year as of the close of which the method provided for in section 22 (d) is first to be applied, together with a description of the functions and operations performed by each department of each such business.

2. A statement describing any changes made, during the preceding taxable year, in the nature of the business or businesses carried on by the taxpayer.

3. A balance sheet as of the beginning of the taxable year as of the close of which such method is first to be applied, and a balance sheet as of the beginning of the preceding taxable year.

4. An analysis of all inventories as of the beginning of the taxable year as of the close of which such method is first to be applied, and of all inventories as of the beginning of the preceding taxable year. Such analysis shall include a description and the amount of each kind of raw materials. In the case of a taxpayer who claims that his principal business is producing brass, copper products, or brass products, or any one or more of them, not further advanced than rods, sheets, tubes, bars, plates, or strips, the analysis of finished goods shall show the amount of each product of a given style, shape, or use. In the case of any other taxpayer, the analysis of finished goods shall show one of the following: (*a*) The cost of each group of products going through the same processes in the factory; (*b*) the cost of each group of products requiring the same kind of raw materials; or (*c*) the cost of each group of products having the same style, shape, or use. Each group of products shall be clearly described.

5. An analysis of all sales made during the taxable year preceding the taxable year as of the close of which such method is first to be applied. In the case of a taxpayer who claims that his principal business is producing brass, copper products, or brass products, or any one or more of them, not further advanced than rods, sheets, tubes, bars, plates, or strips, such analysis shall show the sales of each product of a given style, shape, or use. In the case of any other taxpayer, such analysis shall show one of the following: (*a*) The sales of each group of products going through the same processes in the factory; (*b*) the sales of each group of products requiring the same kind of raw materials; or (*c*) the sales of each group of products of a given style, shape, or use. Each group of products shall be clearly described.

6. A profit and loss statement for the taxable year preceding the taxable year as of the close of which such method is first to be applied, including therein all items of tax-exempt income.

ART. 22 (d)-3. *Adjustments to be made by taxpayer.*—A taxpayer may not change to the method of taking inventories provided for in section 22 (d) unless he agrees to and makes such adjustments, and pays such taxes with respect to such adjustments, in the inventories of prior taxable years or otherwise, as the Commissioner deems necessary to prevent the change in method from resulting in avoidance of tax. See section 22 (d) (6).

ART. 22 (d)-4. *Revocation of election.*—An election made under section 22 (d) is irrevocable and the method so elected shall be applied in all subsequent taxable years in taking inventory of raw materials used in the business to which such method is applicable under the election, notwithstanding any change in the principal business of the taxpayer, unless another method be authorized by the Commissioner pursuant to a written application therefor filed with him. Application for permission to change the method of taking inventory after an election has been made under section 22 (d) shall be filed within 90 days after the beginning of the first taxable year for which such change is to be effective. The permission to make the change will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected.

[SEC. 22. *Gross income.*]

(*e*) *Distributions by corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in section 115.

(*f*) *Determination of gain or loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111.

(*g*) *Gross income from sources within and without United States.*—For computation of gross income from sources within and without the United States, see section 119.

(*h*) *Foreign personal holding companies.*—For provisions relating to gross income of foreign personal holding companies and of their shareholders, see section 334.

(*i*) *Consent dividends.*—For inclusion in gross income of amounts specified in shareholders' consents, see section 28.

CHAPTER IV

Deductions from Gross Income

SEC. 23. *Deductions from gross income.*—In computing net income there shall be allowed as deductions:

(*a*) *Expenses.*—(1) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(2) *Corporate charitable contributions.*—No deduction shall be allowable under paragraph (1) to a corporation for any contribution or gift which would be allowable as a deduction under subsection (q) were it not for the 5 per centum limitation therein contained and for the requirement therein that payment must be made within the taxable year.

ART. 23 (a)-1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 23 (b)-1 to 23 (q)-1. Double deductions are not permitted. Amounts deducted under one provision of the Act cannot again be deducted under any other provision of the Act. As to charitable contributions by corporations not deductible under section 23 (a), see article 23 (a)-13. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. (See article 22 (a)-5.) Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see article 23 (a)-2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. As to items not deductible under any provision of section 23, see section 24.

ART. 23 (a)-2. *Traveling expenses.*—Traveling expenses, as ordinarily understood, include railroad fares and meals and lodging. If the trip is undertaken for other than business purposes, the railroad fares are personal expenses and the meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including railroad fares, meals, and lodging, are business expenses.

(*a*) If, then, an individual, whose business requires him to travel, receives a salary as full compensation for his services, without reimbursement for traveling expenses, or is employed on a commission basis with no expense allowance, his traveling expenses, including the entire amount expended for meals and lodging, are deductible from gross income.

(*b*) If an individual receives a salary and is also repaid his actual traveling expenses, he shall include in gross income the amount so repaid and may deduct such expenses.

(*c*) If an individual receives a salary and also an allowance for meals and lodging, as, for example, a per diem allowance in lieu of subsistence, the amount of the allowance should be included in gross income and the cost of such meals and lodging may be deducted therefrom.

A payment for the use of a sample room at a hotel for the display of goods is a business expense. Only such expenses as are reasonable and necessary in the conduct of the business and directly attributable to it may be deducted. A taxpayer claiming the benefit of the deductions referred to herein must attach to his return a statement showing (1) the nature of the business in which engaged; (2) the number of days away from home during the taxable year on account of business; (3) the total amount of expenses incident to meals and lodging while absent from home on business during the taxable year; and (4) the total amount of other expenses incident to travel and claimed as a deduction.

Claim for the deductions referred to herein must be substantiated, when required by the Commissioner, by evidence showing in detail the amount and nature of the expenses incurred.

Commuters' fares are not considered as business expenses and are not deductible.

ART. 23 (a)-3. *Cost of materials.*—Taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only to the amount that they are actually consumed and used in operation during the year for which the return is made, provided that the cost of such materials and supplies has not been deducted in determining the net income for any previous year. If a taxpayer carries incidental materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, it will be permissible for the taxpayer to include in his expenses and deduct from gross income the total cost of such supplies and materials as were purchased during the year for which the return is made, provided the net income is clearly reflected by this method.

ART. 23 (a)-4. *Repairs.*—The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept. (See articles 23 (l)-1 to 23 (l)-10.)

ART. 23 (a)-5. *Professional expenses.*—A professional man may claim as deductions the cost of supplies used by him in the practice of his profession, expenses paid in the operation and repair of an automobile used in making professional calls, dues to professional societies and subscriptions to professional journals, the rent paid for office rooms, the cost of the fuel, light, water, telephone, etc., used in such offices, and the hire of office assistants. Amounts currently expended for books, furniture, and professional instruments and equipment, the useful life of which is short, may be deducted.

ART. 23 (a)-6. *Compensation for personal services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

ART. 23 (a)-7. *Treatment of excessive compensation.*—The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stock holdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. If such payments constitute payment for property, they should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price. In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in gross income of the recipient and subjected to both normal tax and surtax.

ART. 23 (a)-8. *Bonuses to employees.*—Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are not deductible from gross income.

ART. 23 (a)-9. *Pensions—Compensation for injuries.*—Amounts paid by a taxpayer for pensions to retired employees or to their families or others dependent upon them, or on account of injuries received by employees, and lump-sum amounts paid or accrued as compensation for injuries, are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs, in recognition of the services rendered by the individual, such payments may be deducted. As to deductions for payments to employees' pension trusts, see section 23 (p).

ART. 23 (a)-10. *Rentals.*—If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvements made, this deduction shall take the form of an allowance for depreciation. (See article 22 (a)-13.)

ART. 23 (a)-11. *Expenses of farmers.*—A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The cost of feeding and raising live stock may be treated as an expense deduction, in so far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. Where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may, with the consent of the Commissioner (see article 41-2), be determined upon the crop basis, and such deductions must be taken in the year in which the gross income from the crop has been realized. The cost of farm machinery, equipment, and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may be regarded as investments of capital. Amounts expended in purchasing work, breeding, or dairy animals are regarded as investments of capital, and may be depreciated unless such animals are included in an inventory in accordance with article 22 (a)-7. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital. The cost of gasoline, repairs, and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense. If a farm is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions. (See also articles 22 (a)-7, 23 (e)-5, and 23 (l)-10.)

ART. 23 (a)-12. *Depositors' guaranty fund.*—Banking corporations which pursuant to the laws of the States in which they are doing business are required to set apart, keep, and maintain in their banks the amount levied and assessed against them by the State authorities as a "Depositors' guaranty fund," may deduct from their gross income the amount so set apart each year to this fund, provided that such fund, when set aside and carried to the credit of the State banking board or duly authorized State officer, ceases to be an asset of the bank and may be withdrawn in whole or in part upon demand by such board or State officer to meet the needs of these officers in reimbursing depositors in insolvent banks, and provided further that no portion of the amount thus set aside and credited is returnable under the laws of the State to the assets of the banking corporation. If, however, such amount is simply set up on the books of the bank as a reserve to meet a contingent liability and remains an asset of the bank, it will not be deductible except as it is actually paid out as required by law and upon demand of the proper State officers.

ART. 23 (a)-13. *Corporate contributions.*—No deduction is allowable under section 23 (a) for a contribution or gift by a corporation if any part thereof is deductible under section 23 (q). Thus, for example, if a corporation makes a contribution of $5,000, only $4,000 of which is deductible under section 23 (q) (whether because of the 5 percent limitation or requirement of actual payment, or both), no deduction is allowable under section 23 (a) for the remaining $1,000.

The limitations provided in paragraph (2) of section 23 (a) and in this article apply only to payments which are in fact contributions or gifts to organizations described in section 23 (q). For example, payments by a street railway corporation to a local hospital (which is a charitable organization within the meaning of section 23 (q)) in consideration of a binding obligation on the part of the hospital to provide hospital services and facilities for the corporation's employees are not contributions or gifts within the meaning of section 23 (q) and may be deductible under section 23 (a) if the requirements of that section are otherwise satisfied. Donations to organizations other than those described in section 23 (q) which bear a direct relationship to the corporation's business and are made with a reasonable expectation of a financial return commensurate with the amount of the donation may constitute allowable deductions as business expenses. For example, a street railway corporation may donate a sum of money to an organization (of a class not referred to in section 23 (q)) intending to hold a convention in the city in which it operates, with a reasonable expectation that the holding of such convention will augment its income through a greater number of people using its cars.

[SEC. 23. *Deductions from gross income.*] [In computing net income there shall be allowed as deductions:]

(*b*) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title.

ART. 23 (b)-1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, except that interest on indebtedness incurred or continued to purchase or carry obligations, such as municipal bonds, Panama Canal loan 3 percent bonds, or (in case of a taxpayer not an original subscriber) obligations of the United States issued after September 24, 1917, the interest upon which is wholly exempt from tax, is not deductible. Interest paid or accrued within the year on indebtedness incurred or continued to purchase or carry (*a*) obligations of the United States issued after September 24, 1917, the interest upon which is not wholly exempt from the taxes imposed by Title I, or (*b*) (in the case of an original subscriber) obligations of the United States issued after September 24, 1917, the interest upon which is wholly exempt from the taxes imposed by Title I, is deductible in accordance with the general rule.

Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Payments made for Maryland or Pennsylvania ground rents are not deductible as interest but may, if a proper business expense, be deducted as rent.

Interest calculated for cost-keeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. (See, however, article 22 (a)-18 and section 121.) In the case of banks and loan or trust companies interest paid within the year on deposits such as interest paid on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company may be deducted from gross income. As to other amounts of interest not deductible under section 23 (b), see section 24 (c).

[SEC. 23. *Deductions from gross income.*] [In computing net income there shall be allowed as deductions:]

(c) *Taxes generally.*—Taxes paid or accrued within the taxable year, except—

(1) Federal income, war-profits, and excess-profits taxes (other than the excess-profits tax imposed by section 106 of the Revenue Act of 1935 or by section 602 of this Act);

(2) income, war-profits, and excess-profits taxes imposed by the authority of any foreign country or possession of the United States; but this deduction shall be allowed in the case of a taxpayer who does not signify in his return his desire to have to any extent the benefits of section 131 (relating to credit for taxes of foreign countries and possessions of the United States);

(3) estate, inheritance, legacy, succession, and gift taxes; and

(4) taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not exclude the allowance as a deduction of so much of such taxes as is properly allocable to maintenance or interest charges.

ART. 23 (c)-1. *Taxes.*—Subject to the exceptions stated in this article and articles 23 (c)-2 and 23 (c)-3, taxes imposed by the United States, any State or Territory, or political subdivision of either, possessions of the United States, or foreign countries, are deductible from gross income for the year in which paid or accrued (see section 43). Estate, inheritance, legacy, succession, and gift taxes and Federal income, war-profits, and excess-profits taxes (other than the excess-profits tax imposed by section 106 of the Revenue Act of 1935 or by section 602 of the Revenue Act of 1938) are not deductible from gross income. Income, war-profits, and excess-profits taxes imposed by the authority of any foreign country or possession of the United States are deductible from gross income in cases where the taxpayer does not signify in his return his desire to have to any extent the benefits of section 131 (relating to credit for taxes of foreign countries or possessions of the United States). See generally articles 131-1 to 131-8 as to tax credits. Postage is not a tax. Amounts paid to States or Territories under secured debts laws in order to render securities tax exempt are deductible. Automobile license fees are ordinarily taxes. In general taxes are deductible only by the person upon whom they are imposed. As to tax paid at the source on interest from tax-free covenant bonds, see section 143 (a) (3).

ART. 23 (c)-2. *Federal duties and excise taxes.*—Import or tariff duties paid to the proper customs officers, and business, license, privilege, excise, and stamp taxes paid to internal revenue collectors, are deductible as taxes imposed by the authority of the United States, provided they are not added to and made a part of the expenses of the business or the cost of articles of merchandise with respect to which they are paid, in which case they cannot be separately deducted. (See article 23 (a)-1.)

ART. 23 (c)-3. *Taxes for local benefits.*—So-called taxes, more properly assessments, paid for local benefits, such as street, sidewalk, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied, do not constitute an allowable deduction from gross income. A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. Assessments under the statutes of California relating to irrigation and of Iowa relating to drainage, and under certain statutes of Tennessee relating to levees, are limited to property benefited, and if the assessments are so limited, the amounts paid thereunder are not deductible as taxes. The above statements are subject to the exception that in so far as assessments against local benefits are made for the purpose of maintenance or repair or for the purpose of meeting interest charges with respect to such benefits, they are deductible. In such cases the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation cannot be made, none of the amounts so paid is deductible.

[SEC. 23. *Deductions from gross income.*] [In computing net income there shall be allowed as deductions:]

(*d*) *Taxes of shareholders paid by corporation.*—The deduction for taxes allowed by subsection (c) shall be allowed to a corporation in the case of taxes imposed upon a shareholder of the corporation upon his interest as shareholder which are paid by the corporation without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes.

ART. 23 (d)-1. *Tax on bank or other stock.*—Banks or other corporations paying taxes assessed against their shareholders on account of their ownership of the shares of stock issued by such corporations without reimbursement from such shareholders may deduct the amount of taxes so paid. The Act specifically provides, however, that in such cases the shareholders may not deduct the amount of the taxes. The amount so paid should not be included in the income of the shareholder.

[SEC. 23. *Deductions from gross income.*] [In computing net income there shall be allowed as deductions:]

(e) *Losses by individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

ART. 23 (e)-1. *Losses by individuals.*—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (*a*) incurred in the taxpayer's trade or business, or (*b*) incurred in any transaction entered into for profit, or (*c*) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (*d*) if not prohibited or limited by any of the following sections of the Act: Sections 23 (g) and 117, relating to capital losses; section 23 (h), relating to wagering losses; section 24 (b), relating to losses from sales or exchanges of property between persons designated therein; section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 118, relating to losses on wash sales of stock or securities; section 251, relating to income from sources within possessions of United States; and section 252, relating to citizens of possessions of United States. See section 213 as to limitation upon losses sustained by nonresident aliens.

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. See section 113 (b).

A loss occasioned by damage to an automobile maintained for pleasure, where such damage results from the faulty driving of the taxpayer or other person operating the automobile, but is not due to the willful act or negligence of the taxpayer, is a deductible loss in the computation of net income. If damage to a taxpayer's automobile results from the faulty driving of the operator of an automobile with which the automobile of the taxpayer collides, the loss occasioned to the taxpayer by such damage is likewise deductible.

No loss is realized by the transfer of property by gift or by death. But see section 44 (d).

A loss on the sale of residential property purchased or constructed by the taxpayer for use as his personal residence and so used by him up to the time of the sale is not deductible. If, however, property so purchased or constructed is prior to its sale rented or otherwise appropriated to income-producing purposes and is used for such purposes up to the time of its sale, a loss from the sale of the property, computed as provided in section 111, is, subject to the limitations provided in section 117, an allowable deduction in an amount not to exceed the excess of the value of the property at the time it was appropriated to income-producing purposes (with proper adjustment for depreciation) over the amount realized from the sale.

Example (1): Residential property was purchased by a taxpayer in 1928 for use as his personal residence at a cost of $25,000, of which $15,000 was allocable to the building. The property was so used by the taxpayer until January 1, 1935. From that date to January 1, 1938, when the property was sold, it was rented by the taxpayer. The fair market value of the property at the time it was rented on January 1, 1935, was $22,000, of which $12,000 was allocable to the building. The building had an estimated life of 20 years on January 1, 1935. The property was sold on January 1, 1938, for $16,000. The loss from the sale allowable as a deduction except as limited by section 117 is $4,200, computed as follows:

Cost of property in 1928	$25,000
Less depreciation allowed (not less than amount allowable) in respect of the building (depreciation for 3 years at 5 percent based on $12,000, value of building when converted to business use)	1,800
	23,200
Selling price of property	16,000
Loss computed as provided in section 111	7,200
Value of property at time it was rented on January 1, 1935	22,000
Less proper adjustment for depreciation	1,800
	20,200
Selling price of property	16,000
Portion of $7,200 loss which is deductible except as limited by section 117	4,200

Example (2): If, under the circumstances set forth in example (1), the property had been purchased at a cost of $20,000, of which $10,000 was allocable to the building, but otherwise the facts assumed are the same, the deductible loss, except as limited by section 117, is $2,500, computed as follows:

Cost of property in 1928	$20,000
Less depreciation allowed (not less than amount allowable) in respect of the building (depreciation for 3 years at 5 percent based on $10,000, cost of building)	1,500
	18,500
Selling price of property	16,000
Loss computed as provided in section 111	2,500
Deductible loss, except as limited by section 117	2,500

Losses from the sale or other disposition of Treasury bills issued after June 17, 1930, are not deductible.

ART. 23 (e)-2. *Voluntary removal of buildings.*—Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements is deductible from gross income. When a taxpayer buys real estate upon which is located a building, which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building.

ART. 23 (e)-3. *Loss of useful value.*—When, through some change in business conditions, the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the basis (adjusted as provided in section 113 (b) and articles 113 (a) (14)-1, 113 (b)-1, 113 (b)-2, and 113 (b)-3) and the salvage value of the property. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property has been prematurely discarded, as for example, where an increase in the cost or change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be fully explained in the return of income. The limitations provided in section 117 with respect to the sale or exchange of capital assets have no application to losses due to the discarding of capital assets.

If the depreciable assets of a taxpayer consist of more than one item and depreciation, whether in respect of items or groups of items, is based upon the average lives of such assets, losses claimed on the normal retirement of such assets are not allowable inasmuch as the use of an average rate contemplates a normal retirement of assets both before and after the average life has been reached and there is, therefore, no possibility of ascertaining any actual loss under such circumstances until all assets contained in the group have been retired. In order to account properly for such retirement the entire cost or other basis of assets retired, adjusted for salvage, will be charged to the depreciation reserve account, which will enable the full cost or other basis of the property to be recovered.

In cases in which depreciable property is disposed of due to causes other than exhaustion, wear and tear, and normal obsolescence, such as casualty, obsolescence other than normal, or sale, a deduction for the difference between the basis of the property (adjusted as provided in section 113 (b) and articles 113 (a) (14)-1, 113 (b)-1, 113 (b)-2, and 113 (b)-3) and its salvage value and/or amount realized upon its disposition may be alowed subject to the limitations provided in the Act upon deductions for losses, but only if it is clearly evident that such disposition was not contemplated in the rate of depression.

In the case of classified accounts, if it is the consistent practice of the taxpayer to base the rate of depreciation on the expected life of the longest lived asset contained in the account, or in the case of single item accounts if the rate of depreciation is based on the maximum expected life of the asset, a deduction for the basis of the asset (adjusted as provided in section 113 (b) and articles 113 (a) (14)-1, 113 (b)-1, 113 (b)-2, and 113 (b)-3) less its salvage value is allowable upon its retirement. (See articles 23 (l)-1 to 23 (l)-10.)

ART. 23 (e)-4. *Shrinkage in value of stocks.*—A person possessing stock of a corporation cannot deduct from gross income any amount claimed as a loss merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the stock is disposed of. If stock of a corporation becomes worthless, its cost or other basis as determined and adjusted under section 113 and articles 113 (b)-1 to 113 (b)-3 is deductible by the owner for the taxable year in which the stock became worthless, provided a satisfactory showing is made of its worthlessness. Federal or State authorities incident to the regulation of banks and certain other corporations may require that stock be charged off as worthless or written down to a nominal value. If, in any such case, the basis of the requirement is the worthlessness of the stock, such charging off or writing down will, for income tax purposes, be considered prima facie evidence of worthlessness; but if the charging off or writing down is due to market fluctuations, or if no reasonable attempt has been made to determine worthlessness, no deduction for income tax purposes of the amount so charged off or written down can be allowed. For dealers in securities, see article 22 (c)-5. For limitations on deductions for losses from sales or exchanges of capital assets generally, including stocks and bonds, see section 117.

ART. 23 (e)-5. *Losses of farmers.*—Losses incurred in the operation of farms as business enterprises are deductible from gross income. If farm products are held for favorable markets, no deduction on account of shrinkage in weight or physical value or by reason of deterioration in storage shall be allowed, except as such shrinkage may be reflected in an inventory if used to determine profits. The total loss by frost, storm, flood, or fire of a prospective crop is not a deductible loss in computing net income. A farmer engaged in raising and selling stock, such as cattle, sheep, horses, etc., is not entitled to claim as a loss the value of animals that perish from among those animals that were raised on the farm, except as such loss is reflected in an inventory if used. If live stock has been purchased after February 28, 1913, for any purpose, and afterwards dies from disease, exposure, or injury, or is killed by order of the authorities of a State or the United States, the actual purchase price of such live stock, less any depreciation allowable as a deduction in respect of such perished live stock, may be deducted as a loss if the loss is not compensated for by insurance or otherwise. The actual cost of other property (with proper adjustment for depreciation) which is destroyed by order of the authorities of a State or of the United States, may in like manner be claimed as a loss. If reimbursement is made by a State or the United States in whole or in part on account of stock killed or other property destroyed in respect of which a loss was claimed for a prior year, the amount received shall be reported as income for the year in which reimbursement is made. The cost of any feed, pasture, or care which has been deducted as an expense of operation shall not be included as part of the cost of the stock for the purpose of ascertaining the amount of a deductible loss. If gross income is ascertained by inventories, no deduction can be made for live stock or products lost during the year, whether purchased for resale or produced on the farm, as such losses will be reflected in the inventory by reducing the amount of live stock or products on hand at the close of the year. If an individual owns and operates a farm, in addition to being engaged in another trade, business, or calling, and sustains a loss from such operation of the farm, then the amount of loss sustained may be deducted from gross income received from all sources, provided the farm is not operated for recreation or pleasure. As to losses claimed as deductions for estate tax purposes, see article 23 (e)-1. See also articles 22 (a)-7, 23 (a)-11, and 23 (l)-10.

[SEC. 23. *Deductions from gross income.*]
[In computing net income there shall be allowed as deductions:]

(*f*) *Losses by corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

ART. 23 (f)-1. *Losses by corporations.*—Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible in so far as not prohibited or limited by sections 23 (g), 23 (h), 24 (b), 112, 117, 118, and 251. The provisions of articles 23 (e)-1, 23 (e)-2, 23 (e)-3, 23 (e)-4, 23 (e)-5, and 23 (i)-1 are in general applicable to corporations as well as individuals. See section 232 as to deductions by foreign corporations.

[SEC. 23. *Deductions from gross income.*]
[In computing net income there shall be allowed as deductions:]

(*g*) *Capital losses.*—(1) *Limitation.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117.

(2) *Securities becoming worthless.*—If any securities (as defined in paragraph (3) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this title, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

(3) *Definition of securities.*—As used in this subsection the term "securities" means (A) shares of stock in a corporation, and (B) rights to subscribe for or to receive such shares.

ART. 23 (g)-1. *Capital losses.*—Section 23 (g) provides in effect that deductions allowed to individuals under section 23 (e) and to corporations under section 23 (f) for losses sustained on the sale or exchange of a capital asset shall be limited in amount to the extent provided in section 117. Losses sustained by virtue of securities becoming worthless during the taxable year are, under section 23 (g), made subject to the limitations provided in section 117 with respect to sales or exchanges. For purposes of computing the net income of any taxpayer, such losses are to be considered as being sustained from the sale or exchange of the securities on the last day of the taxable year, irrespective of when during the taxable year such securities actually became worthless.

As used in section 23 (g) and this article the term "securities" means shares of stock in a domestic or foreign corporation and rights to subscribe for or to receive such shares, which shares or rights are capital assets within the meaning of section 117 (a).

The application of section 23 (g) may be illustrated as follows:

Example: A, an individual, who is not a dealer in corporate stocks or stock rights and whose taxable year is the calendar year, purchased 120 shares of stock in the X Corporation on February 1, 1937, for which he paid $3,000. In June, 1938, the stock became worthless. A is entitled to a deduction of $2,000 in computing his net income for 1938. The deduction is computed as follows:

Purchase price	$3,000
Amount realized	None
Actual loss	$3,000
Period stock considered to have been held (February 1, 1937, to December 31, 1938)	23 months
Percentage of loss taken into account under section 117 (b)	66⅔ percent
Long-term capital loss (66⅔ percent of $3,000) (section 117 (a) (5))	$2,000

[SEC. 23. *Deductions from gross income.*] [In computing net income there shall be allowed as deductions:]

(*h*) *Wagering losses.*—Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

(*i*) *Basis for determining loss.*—The basis for determining the amount of deduction for losses sustained, to be allowed under subsection (e) or (f), and for bad debts, to be allowed under subsection (k), shall be the adjusted basis provided in section 113 (b) for determining the loss from the sale or other disposition of property.

ART. 23 (i)–1. *Basis for determining loss.*—The basis for determining the amount of the deduction for losses allowed to individuals under section 23 (e) and to corporations under section 23 (f), or of the amount of the deduction for bad debts allowed to both individuals and corporations under section 23 (k), is the same as is provided in section 113 for determining the loss from the sale or other disposition of property. Proper adjustment must be made in each case for any expenditure, receipt, loss, or other item properly chargeable to capital account, and for depreciation, obsolescence, amortization, or depletion. (See section 113 (b) and articles 113 (b)–1 to 113 (b)–3).

[SEC. 23. *Deductions from gross income.*] [In computing net income there shall be allowed as deductions:]

(*j*) *Loss on wash sales of stock or securities.*—For disallowance of loss deduction in the case of sales of stock or securities where within thirty days before or after the date of the sale the taxpayer has acquired substantially identical property, see section 118.

(*k*) *Bad debts.*—(1) *General rule.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection.

(2) *Securities becoming worthless.*—If any securities (as defined in paragraph (3) of this subsection) are ascertained to be worthless and charged off within the taxable year and are capital assets, the loss resulting therefrom shall, in the case of a taxpayer other than a bank, as defined in section 104, for the purposes of this title, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

(3) *Definition of securities.*—As used in this subsection the term "securities" means bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form.

ART. 23 (k)–1. *Bad debts.*—(*a*) Bad debts may be treated in either of two ways—

(1) By a deduction from income in respect of debts ascertained to be worthless in whole or in part, or

(2) By a deduction from income of an addition to a reserve for bad debts.

Taxpayers were given an option for 1921 to select either of the methods mentioned for treating such debts. (See article 151, Regulations 62.) The method used in the return for 1921 must be used in returns for subsequent years and in returns under the Revenue Act of 1938 unless permission is granted by the Commissioner to change to the other method. A taxpayer filing a first return of income may select either of the two methods subject to approval by the Commissioner upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, except as permission may be granted by the Commissioner to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30 days prior to the close of the taxable year for which the change is to be effective. (See also article 23 (k)–5.)

(*b*) If all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. No deduction shall be allowed for the part of a debt ascertained to be worthless and charged off prior to January 1, 1921, unless and until the debt is ascertained to be totally worthless and is finally charged off or is written down to a nominal amount, or the loss is determined in some other manner by a closed and completed transaction. Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off and allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Partial deductions will be allowed with respect to specific debts only.

Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for the purpose of deduction. Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt. Actual determination of worthlessness in bankruptcy cases is sometimes possible before and at other times only when a settlement in bankruptcy shall have been had. Where a taxpayer ascertained a debt to be worthless and charged it off in one year, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, confirming the conclusion that the debt is worthless, will not authorize shifting the deductions to such later year. If a taxpayer computes his income upon the basis of valuing his notes or accounts receivable at their fair market value when received, which may be less than their face value, the amount deductible for bad debts in any case is limited to such original valuation.

(*c*) Where banks or other corporations which are subject to supervision by Federal authorities (or by State authorities maintaining substantially equivalent standards) in obedience to the specific orders of such supervisory officers charge off debts in whole or in part, such debts shall be conclusively presumed, for income tax purposes, to be worthless or recoverable only in part, as the case may be, but in order that any amount of the charge-off may be allowed as a deduction for any taxable year it must be shown that the charge-off took place within such taxable year.

(*d*) The provisions of subdivisions (*a*) and (*b*) of this article apply to all taxpayers, except that in the case of taxpayers other than banks as defined in section 104, the term "debts" as used in such subdivisions means obligations to pay fixed or determinable sums of money which are not evidenced by securities as defined in article 23 (k)–4.

ART. 23 (k)–2. *Examples of bad debts.*—Worthless debts arising from unpaid wages, salaries, rents, and similar items of taxable income will not be allowed as a deduction unless the income such items represent has been included in the return of income for the year for which the deduction as a bad debt is sought to be made or for a previous year. Only the difference between the amount received in distribution of the assets of a bankrupt and the amount of the claim may be deducted as a bad debt. The difference between the amount received by a creditor of a decedent in distribution of the assets of the decedent's estate and the amount of his claim may be considered a worthless debt. A purchaser of accounts receivable which can not be collected and are consequently charged off the books as bad debts is entitled to deduct them, the amount of deduction to be based upon the price he paid for them and not upon their face value.

ART. 23 (k)-3. *Uncollectible deficiency upon sale of mortgaged or pledged property.*—If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the mortgagee or pledgee ascertains that the portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off, he may deduct such amount (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it is ascertained to be wholly or partially worthless and charged off. In addition, if the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

Accrued interest may be included as part of the deduction only if it has previously been returned as income.

ART. 23 (k)-4. *Worthless bonds and similar obligations.*—Except only in the case of a bank, as defined in section 104, no deduction is allowable under paragraph (1) of section 23 (k) to any taxpayer with respect to a debt (evidenced by a security) which has become worthless in whole or in part. If a security is ascertained to be worthless and is charged off during the taxable year, a deduction for the loss resulting therefrom is allowable under paragraph (2) of section 23 (k). Such a loss, however, is made subject to the limitations provided in section 117 with respect to sales or exchanges. For the purposes of computing the net income of any taxpayer, other than a bank as defined in section 104, such a loss is to be considered as being sustained from the sale or exchange of the security on the last day of the taxable year, irrespective of when during the taxable year such security was ascertained to be worthless and charged off as required. No deduction is allowable under paragraph (2) of section 23 (k) with respect to a debt evidenced by a security which is recoverable in part.

As used in section 23 (k) and this article the term "security" means a bond, debenture, note, or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which (1) is a capital asset as defined in section 117 and (2) has been issued at any time by a domestic or foreign corporation (including that issued by any government or political subdivision thereof), either in registered form or accompanied by interest coupons.

A bond issued by an individual, if ascertained to be worthless, may be treated as a bad debt. A bond of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders is regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for a subsequent year.

A taxpayer (other than a dealer in bonds or other similar obligations) possessing debts evidenced by bonds or other similar obligations cannot deduct from gross income any amount merely on account of market fluctuation. If a taxpayer ascertains, however, that due, for instance, to the financial condition of the debtor, or conditions other than market fluctuation, he will recover upon maturity none or only a part of the debt evidenced by the bonds or other similar obligations (which bonds or other obligations are not securities as defined in this article) and so demonstrates to the satisfaction of the Commissioner, he may deduct in computing net income the uncollectible part of the debt evidenced by the bonds or other similar obligations. A bank as defined in section 104 may deduct such uncollectible part of the debt even though the evidence of the debt is a security as defined in this article.

The application of section 23 (k) to deductions for worthless bonds and similar obligations which are securities may be illustrated by the following examples:

Example (1): On February 1, 1937, A, an individual, who is not a dealer in corporate bonds, purchased bonds of the X Corporation bearing interest coupons payable semiannually, for which he paid $3,000. During the calendar year 1938 (his taxable year) the bonds became worthless and he made a proper charge-off during that year. A is entitled to a deduction of $2,000 in computing his net income for 1938. The computation of the amount of the deduction is the same as the computation in the example under article 23 (g)-1.

Example (2): If the facts in example (1) are the same except that because of the financial condition of the X Corporation the debt evidenced by its bonds became recoverable only in part no deduction is allowable to A under either paragraph (1) or (2) of section 23 (k) with respect to the uncollectable part of such debt.

ART. 23 (k)-5. *Reserve for bad debts.*—Taxpayers who have established the reserve method of treating bad debts and maintained proper reserve accounts for bad debts, or who, in accordance with article 23 (k)-1 adopt the reserve method of treating bad debts, may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of a deduction for specific bad debt items.

What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve. In case subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve should be reflected in the determination of the reasonable addition necessary in the taxable year. A taxpayer using the reserve method should make a statement in his return showing the volume of his charge sales (or other business transactions) for the year and the percentage of the reserve to such amount, the total amount of notes and accounts receivable at the beginning and close of the taxable year, and the amount of the debts which have been ascertained to be wholly or partially worthless and charged against the reserve account during the taxable year.

[SEC. 23. *Deductions from gross income.*]
[In computing net income there shall be allowed as deductions:]

(*l*) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

ART. 23 (l)-1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonable consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the cost or other basis of the property determined in accordance with section 113. Due regard must also be given to expenditures for current upkeep. In the case of property held by one person for life with remainder to another person, the deduction for depreciation shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, will be allowed to the remainderman. In the case of property held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the will, deed, or other instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income which is allocable to the trustee and the beneficiaries, respectively. For example, if the trust instrument provides that the income of the trust computed without regard to depreciation shall be distributed to a named beneficiary, such beneficiary will be entitled to the depreciation allowance to the exclusion of the trustee, while if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee.

ART. 23 (1)-2. *Depreciable property.*—The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply to inventories or to stock in trade, or to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provisions for this being made in the Act. (See sections 23 (m) and 114.) Property kept in repair may, nevertheless, be the subject of a depreciation allowance. (See article 23 (a)-4.) The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business. No such allowance may be made in respect of automobiles or other vehicles used solely for pleasure, a building used by the taxpayer solely as his residence, or in respect of furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be the subject of a depreciation allowance.

ART. 23 (1)-3. *Depreciation of intangible property.*—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. No deduction for depreciation, including obsolescence, is allowable in respect of good will.

ART. 23 (1)-4. *Capital sum recoverable through depreciation allowances.*—The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See sections 113 (a) and 114.) To this amount should be added from time to time the cost of improvements, additions, and betterments, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility which is the basis of the depreciation allowance. (See section 113 (b).) In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump price, as, for example, buildings and land, the capital sum to be replaced is limited to an amount which bears the same proportion to the lump price as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time. If the lessee of real property erects buildings, or makes permanent improvements which become part of the realty and income has been returned by the lessor as a result thereof, as provided in paragraphs (*b*) and (*c*) of article 22 (a)-13, the capital sum to be replaced by depreciation allowances is held to be the same as though no such buildings had been erected or such improvements made. In the case of property which has been the subject of deductions for amortization under sections 214 (a) (9) and 234 (a) (8) of the Revenue Acts of 1918 and 1921, depreciation deductions will be computed after the close of the amortization period upon the cost or other basis of such property after the amortization allowance has been deducted. No depreciation deduction will be allowed in the case of property which has been amortized to its scrap value and is no longer in use.

ART. 23 (1)-5. *Method of computing depreciation allowance.*—The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made. If the cost or other basis of the property has been recovered through depreciation or other allowances no further deduction for depreciation shall be allowed. The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, taxpayers must furnish full and complete information with respect to the cost or other basis of the assets in respect of which depreciation is claimed, their age, condition, and remaining useful life, the portion of their cost or other basis which has been recovered through depreciation allowances for prior taxable years, and such other information as the Commissioner may require in substantiation of the deduction claimed.

A taxpayer is not permitted under the law to take advantage in later years of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. This paragraph may be illustrated by the following example:

Example: An asset was purchased January 1, 1933, at a cost of $10,000. The useful life of the asset is 10 years. It has no salvage value. Depreciation was deducted and allowed for 1933 to 1937 as follows:

1933	$1,000.00
1934	----------
1935	2,000.00
1936	2,000.00
1937	----------
Total amount allowed	5,000.00

The correct amended reserve as of December 31, 1937, is computed as follows:

December 31:	
1933	$1,000.00
1934	1,000.00
1935	2,000.00
1936	2,000.00
1937	666.67
Reserve December 31, 1937	6,666.67

Depreciation for 1938 and subsequent taxable years is $666.67 computed as follows:

Cost	$10,000.00
Reserve as of December 31, 1937	6,666.67
Unrecovered cost	3,333.33
Depreciation allowable for 1938 and each subsequent taxable year (6⅔ per cent of $10,000)	666.67

ART. 23 (l)–6. *Obsolescence.*—With respect to physical property the whole or any portion of which is clearly shown by the taxpayer as being affected by economic conditions that will result in its being abandoned at a future date prior to the end of its normal useful life, so that depreciation deductions alone are insufficient to return the cost or other basis at the end of its economic term of usefulness, a reasonable deduction for obsolescence, in addition to depreciation, may be allowed in accordance with the facts obtaining with respect to each item of property concerning which a claim for obsolescence is made. No deduction for obsolescence will be permitted merely because, in the opinion of a taxpayer, the property may become obsolete at some later date. This allowance will be confined to such portion of the property on which obsolescence is definitely shown to be sustained and cannot be held applicable to an entire property unless all portions thereof are affected by the conditions to which obsolescence is found to be due.

ART. 23 (l)–7. *Depreciation of patent or copyright.*—In computing a depreciation allowance in the case of a patent or copyright, the capital sum to be replaced is the cost or other basis of the patent or copyright. The allowance should be computed by an apportionment of the cost or other basis of the patent or copyright over the life of the patent or copyright since its grant, or since its acquisition by the taxpayer, or in the case of a copyright, since March 1, 1913, as the case may be. If the patent or copyright was acquired from the Government, its cost consists of the various Government fees, cost of drawings, experimental models, attorneys' fees, development or experimental expenses, etc., actually paid. Depreciation of a copyright can be taken on the basis of the fair market value as of March 1, 1913, only when affirmative and satisfactory evidence of such value is offered. Such evidence should whenever practicable be submitted with the return. If the patent becomes obsolete prior to its expiration, such proportion of the amount on which its depreciation may be based as the number of years of its remaining life bears to the whole number of years intervening between the basic date and the date when it legally expires may be deducted, if permission so to do is specifically secured from the Commissioner. Owing to the difficulty of allocating to a particular year the obsolescence of a patent, such permission will be granted only if affirmative and satisfactory evidence that the patent became obsolete in the year for which the return is made is submitted to the Commissioner. The fact that depreciation has not been taken in prior years does not entitle the taxpayer to deduct in any taxable year a greater amount for depreciation than would otherwise be allowable.

ART. 23 (l)–8. *Depreciation of drawings and models.*—If a taxpayer has incurred expenditures in his business for designs, drawings, patterns, models, or work of an experimental nature calculated to result in improvement of his facilities or his product, and if the period of usefulness of any such asset may be estimated from experience with reasonable accuracy, it may be the subject of depreciation allowances spread over such estimated period of usefulness. The facts must be fully shown in the return or prior thereto to the satisfaction of the Commissioner. Except for such depreciation allowances no deduction shall be made by the taxpayer against any sum so set up as an asset except on the sale or other disposition of such asset at a loss or on proof of a total loss thereof.

ART. 23 (l)–9. *Records of depreciable property.*—In order that the verification of depreciation allowances claimed by the taxpayer may be facilitated, depreciation shall be recorded on the taxpayer's books, the amount measuring a reasonable allowance for depreciation either being deducted directly from the book value of the assets or preferably being credited to a depreciation reserve account, which should be reflected in the annual balance sheet. For the same reason the allowances shall be computed and recorded with express reference to specific items, units, or groups of property, each item or unit being considered separately or specifically included in a group with others to which the same factors apply. Also, the taxpayer's books shall show the basis of the depreciable property and any adjustments thereto, and, in cases where the basis of the property is other than cost, or value on March 1, 1913, or value at date of acquisition (as, for example, if the property was acquired by gift or transfer in trust after December 31, 1920), or through a reorganization or a tax-free exchange (see particularly section 113 (a)), the books shall show the data used in ascertaining such basis and the adjustments thereto. If a taxpayer does not desire to have his regular books of account show all of the factors entering into the computation of depreciation allowances, such factors shall be recorded in permanent auxiliary records which shall be kept with and reconciled with the regular books of account.

ART. 23 (l)–10. *Depreciation in the case of farmers.*—A reasonable allowance for depreciation may be claimed on farm buildings (other than a dwelling occupied by the owner), farm machinery, and other physical property. A reasonable allowance for depreciation may also be claimed on live stock acquired for work, breeding, or dairy purposes, unless they are included in an inventory used to determine profits in accordance with article 22 (a)–7. Such depreciation should be based on the cost or other basis and the estimated life of the live stock. If such live stock be included in an inventory no depreciation thereof will be allowed, as the corresponding reduction in their value will be reflected in the inventory. (See also articles 23 (a)–11 and 23 (e)–5.)

[SEC. 23. *Deductions from gross income.*] [In computing net income there shall be allowed as deductions:]

(*m*) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).)

(*n*) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

ART. 23 (m)–1. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under these provisions of the Act the owner of an interest in mineral deposits, mineral properties, or timber, whether freehold or leasehold, is allowed annual depletion and depreciation deductions which, in the aggregate, will return to him the cost or other basis of such property as provided in section 113, plus, in either case, subsequent allowable capital additions (see articles 23 (m)–15 and 23 (m)–16) with the following exceptions and qualifications:

(1) In the case of coal mines, metal mines, sulphur mines or deposits, and oil and gas wells the aggregate annual allowable deductions may, because of

percentage depletion, ultimately exceed the cost or other basis;

(2) In the case of coal mines, metal mines, and sulphur mines or deposits the aggregate annual allowable deductions may never be as great as the cost or other basis, if an election of the percentage depletion method is made in his first return under Title I of the Act; and

(3) In the case of mines other than metal, coal, or sulphur mines the aggregate annual allowable deductions may exceed the cost or other basis because of the discovery provision.

Operating owners, lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation, but a shareholder in a mining or oil or gas corporation is not allowed such deductions with respect to the property of the corporation. But see article 115-6.

The principles governing the apportionment of depreciation in the case of property held by one person for life with remainder to another person and in the case of property held in trust are also applicable to depletion. (See article 23 (l)-1.)

When used in these articles (23 (m)-1 to 23 (m)-28) covering depletion and depreciation—

(*a*) The "fair market value" of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase.

(*b*) A "mineral property" is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction. The value of a mineral property is the combined value of its component parts.

(*c*) A "mineral deposit" refers to minerals only, such as the ores only in the case of a mine, to the oil only in the case of an oil well, and to the gas only in the case of a gas well, and to the oil and gas in the case of a well producing both oil and gas. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

(*d*) "Minerals" includes ores of the metals, coal, oil, gas, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gravel, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand, silica, slate, soapstone, soda, sulphur, and talc.

(*e*) "Operating profits" is the net amount received from the sale of minerals before depletion and depreciation are deducted. It is distinct from net income, as defined in section 21, and from the net income from the property as defined in paragraph (*h*) of this article.

(*f*) The term "mine" does not include oil and gas wells.

(*g*) "Gross income from the property" as used in section 114 (b) (3) and (4) and articles 23 (m)-1 to 23 (m)-28, inclusive, means the amount for which the taxpayer sells (*a*) the crude mineral product of the property or (*b*) the product derived therefrom, not to exceed in the case of (*a*) the representative market or field price (as of the date of sale) of crude mineral product of like kind and grade before transportation from the immediate vicinity of the mine or well, or in the case of (*b*) the representative market or field price (as of the date of sale) of a product of the kind and grade from which the product sold was derived, before the application of any processes (to which the crude mineral product may have been subjected after emerging from the mine or well) with the exception of those listed below, and before transportation from the place where the last of the processes listed below was applied. If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes minus the costs (including transportation costs) of the processes not listed below. The processes excepted are as follows:

(1) In the case of coal—cleaning, breaking, sizing, and loading at the mine for shipment;

(2) In the case of sulphur—pumping to vats, cooling, breaking, and loading at the mine for shipment;

(3) In the case of iron ore and ores which are customarily sold in the form of the crude mineral product—sorting or concentrating to bring to shipping grade, and loading at the mine for shipment; and

(4) In the case of lead, zinc, copper, gold, or silver ores and ores which are not customarily sold in the form of the crude mineral product—crushing, concentrating (by gravity or flotation), and other processes to the extent to which they do not beneficiate the product in greater degree (in relation to the crude mineral product on the one hand and the refined product on the other) than crushing and concentrating (by gravity or flotation).

In the case of oil and gas, if the crude mineral product is not sold on the property but is manufactured or converted into a refined product or is transported from the property prior to the sale, then the "gross income from the property" shall be assumed to be equivalent to the market or field price of the oil or gas before conversion or transportation.

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in the form of bonus payments or advanced royalties (see article 23 (m)-10) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from "gross income from the property" for the taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the products sold during the taxable year.

(*h*) "Net income of the taxpayer (computed without allowance for depletion) from the property," as used in section 114 (b) (2), (3), and (4) and articles 23 (m)-1 to 23 (m)-28, inclusive, means the "gross income from the property" as defined in paragraph (*g*) less the allowable deductions attributable to the mineral property upon which the depletion is claimed and the allowable deductions attributable to the processes listed in paragraph (*g*) in so far as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. Deductions not directly attributable to particular properties or processes shall be fairly allocated. To illustrate: In cases where the taxpayer engages in activities in addition to mineral extraction and to the processes listed in paragraph (*g*), deductions for depreciation, taxes, general expenses, and overhead, which cannot be directly attributed to any specific activity, shall be fairly apportioned between (1) the mineral extraction and the processes listed in paragraph (*g*) and (2) the additional activities, taking into account the ratio which the operating expenses directly attributable to the mineral extraction and the processes listed in paragraph (*g*) bear to the operating expenses directly attributable to the additional activities. If more than one mineral property is involved, the deductions apportioned to the mineral extraction and the processes listed in paragraph (*g*) shall, in turn, be fairly apportioned to the several properties, taking into account their relative production.

(*i*) "Crude mineral product," as used in paragraph (*g*) of this article, means the product in the form in which it emerges from the mine or well.

(*j*) "The property," as used in section 114 (b) (2), (3), and (4) and articles 23 (m)-1 to 23 (m)-19, inclusive, means the interest owned by the taxpayer, freehold or leasehold, in any mineral property. The taxpayer's interest in each separate mineral property is a separate "property"; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single "property," provided such treatment is consistently followed.

ART. 23 (m)-2. *Computation of depletion of mines, oil and gas wells, and other natural deposits without reference to discovery value or percentage depletion.*—The basis upon which depletion, other than discovery depletion or percentage depletion, is to be allowed in respect of any property is the basis provided in section 113 (a), adjusted as provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property. (See articles 113 (a)-1 to 114-1.) If the amount of the basis as adjusted applicable to the mineral deposit has been determined for the taxable year, the depletion for that year shall be computed by dividing that amount by the number of units of mineral remaining as of the taxable year, and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year. In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

As used in this article the phrase, "number of units sold within the taxable year," in the case of a taxpayer reporting income on the cash receipts and disbursements basis, includes units for which payments were received within the taxable year although produced or sold prior to the taxable year, and excludes units sold but not paid for in the taxable year. The phrase does not include units with respect to which depletion deductions were allowed or allowable prior to the taxable year.

"The number of units of mineral remaining as of the taxable year" is the number of units of mineral remaining at the end of the year to be recovered from the property (including units recovered but not sold) plus the "number of units sold within the taxable year" as defined in this article.

In determining the amount of the basis as adjusted applicable to the mineral deposit there shall be excluded (*a*) amounts representing the cost or value of the land for purposes other than mineral production, (*b*) the amount recoverable through depreciation and through deductions other than depletion, and (*c*) the residual value of other property at the end of operations, but there shall be included, in the case of oil and gas wells, those amounts of capitalized drilling and development costs which, as provided in article 23 (m)-16, are recoverable through depletion.

In the case of a natural gas well where the annual production is not metered and is not capable of being estimated with reasonable accuracy, the taxpayer may compute the depletion allowance (without reference to percentage depletion) in respect of such property for the taxable year by multiplying the adjusted basis of the property by a fraction, the numerator of which is equal to the decline in closed or rock pressure during the taxable year and the denominator of which is equal to the expected total decline in closed or rock pressure from the taxable year to the economic limit of production. Taxpayers computing depletion by this method must keep accurate records of periodical pressure determinations.

ART. 23 (m)-3. *Computation of depletion of mines (other than metal, coal, or sulphur mines) on the basis of discovery value.*—The basis upon which depletion is to be computed in the case of mines (other than metal, coal, or sulphur mines) discovered by the taxpayer after February 28, 1913, is the fair market value of the property at the date of discovery or within 30 days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to cost. The value must be equitably apportioned between the lessor and the lessee. For the method of determining whether a discovery has been made, see article 23 (m)-14. For the method of determining the fair market value, see article 23 (m)-7.

With respect to any property for which discovery value is the taxpayer's basis for depletion, the depletion for any taxable year shall be computed by (1) adding to the discovery value of the mineral deposit in the property any subsequent allowable capital additions made by the taxpayer, (2) subtracting the aggregate of depletion deductions with respect to the property which would previously have been allowable to the taxpayer without the application of any net income limitation, (3) dividing the remainder by the number of units of mineral remaining as of the taxable year, and (4) multiplying the depletion unit, thus determined, by the number of units of mineral sold within the taxable year.

The depletion allowance based on discovery value under this article shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion be less than it would be if computed without reference to discovery value. For definition of "net income of the taxpayer (computed without allowance for depletion) from the property," see article 23 (m)-1 (*h*).

This article does not apply to metal mines, coal mines, sulphur mines or deposits, or to oil or gas wells.

As used in this article the phrase, "number of units sold within the taxable year," in the case of a taxpayer reporting income on the cash receipts and disbursements basis, includes units for which payments were received within the taxable year although produced and sold prior to the taxable year, and excludes units sold but not paid for in the taxable year. The phrase does not include units with respect to which depletion deductions were allowed or allowable prior to the taxable year.

"The number of units of mineral remaining as of the taxable year" is the number of units of mineral remaining at the end of the year to be recovered from the property (including units recovered but not sold) plus the "number of units sold within the taxable year" as defined in this article.

ART. 23 (m)-4. *Computation of depletion based on a percentage of income in the case of oil and gas wells.*—Under section 114 (b) (3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ percent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see article 23 (m)-1 (*g*) and (*h*).) In no case shall the deduction computed under this article be less than it would be if computed upon the cost or other basis of the property provided in section 113.

ART. 23 (m)-5. *Computation of depletion based on a percentage of income in the case of coal mines, metal mines, and sulphur mines or deposits.*—Under section 114 (b) (4) a taxpayer may deduct for depletion an amount equal to 5 percent of the gross income from the property during the taxable year in the case of coal mines, an amount equal to 15 percent of the gross income from the property during the taxable year in the case of metal mines, and an amount equal to 23 percent of the gross income from the property during the taxable year in the case of sulphur mines or deposits, but such deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see article 23 (m)-1 (*g*) and (*h*).)

Subject to the qualification specified in the last sentence of this paragraph, a taxpayer making his first return under Title I of the Act (for a taxable year beginning after December 31, 1937) in respect of a property must state as to each such property whether he elects to have the depletion allowance for each such property for the taxable year computed with or without reference to percentage depletion. For the purpose of this article the taxpayer's first return under Title I of the Act in respect of a property is the return made under that title for his first taxable year (beginning after December 31, 1937) for which he has any item of income or deduction with respect to such property. An election once exercised under section 114 (b) (4) and this article cannot thereafter be changed by the taxpayer, and the depletion allowance in respect of each such property will for all succeeding taxable years be computed in accordance with the election so made. If the taxpayer fails to make such statement in the return in which the election should be so indicated, the depletion allowance for the year for which an election must be first exercised and for all succeeding taxable years will be computed without reference to percentage depletion. The method, determined under section 114 (b) (4) and this article, of computing the depletion allowance shall be applied in the case of the property for all taxable years in which it is in the hands of such taxpayer, or of any other person if the basis of the property (for determining gain) in his hands is, under section 113, determined by reference to the basis in the hands of such taxpayer, either directly or through one or more substituted bases, as defined in that section. The right of election specified in this paragraph is subject to the qualification that section 114 (b) (4) shall, for the purpose of determining whether the method of computing the depletion allowance follows the property, be considered a continuation of section 114 (b) (4) of the Revenue Act of 1934 and the Revenue Act of 1936, and as giving no new election in cases where either of such sections would, if applied, give no new election.

ART. 23 (m)–6. *Determination of cost of deposits.*—In any case in which a depletion or depreciation deduction is computed on the basis of the cost or price at which any mine, mineral deposit, mineral right, or leasehold was acquired, the owner or lessee will be required to show that the cost or price at which the property was bought was fixed for the purpose of a bona fide purchase and sale by which the property passed in fact as well as in form to an owner other than the vendor. No fictitious or inflated cost or price will be permitted to form the basis of any calculation of a depletion or depreciation deduction, and in determining whether the price or cost at which any purchase or sale was made represented the actual market value of the property sold, due weight will be given to the relationship or connection existing between the person selling the property and the buyer thereof.

ART. 23 (m)–7. *Determination of fair market value of mineral properties, including oil and gas properties.*—(*a*) If the fair market value of the property at a specified date is to be determined for the purpose of ascertaining the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or subsequent improvements in methods of extraction and treatment of the mineral product. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purpose of the capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, and, in the absence of better evidence, disinterested appraisals by approved methods. Valuations by analytic appraisal methods, such as the present value method, are not entitled to great weight, (1) if the value of a mineral deposit can be determined upon the basis of cost or replacement value, (2) if the knowledge of the presence of the mineral has not greatly enhanced the value of the mineral property, (3) if the removal of the mineral does not materially reduce the value of the property from which it is taken, or (4) if the profits arising from the exploitation of the mineral deposit are wholly or in great part due to the manufacturing or marketing ability of the taxpayer or to extrinsic causes other than the possession of the mineral itself. If the fair market value must be ascertained as of a certain date, analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method.

(*b*) To determine the fair market value of a mineral property by the present value method, the essential factors must be determined for each deposit included in the property. The factors essential in the case of all mineral deposits are (1) the total operating profit, (2) the rate at which this profit will be obtained, and (3) the rate of interest commensurate with the risk for the particular deposit. In case of oil and gas properties the additional factors are (A) the total quantity of oil and gas in terms of the principal or customary unit (or units) paid for in the product marketed, (B) the quantity of oil and gas expected to be recovered during each operating period, (C) the average quality or grade of the oil and gas reserves, (D) the expected percentage of recovery in each process or operation necessary for the preparation of the oil and gas for market, (E) the probable operating life of the deposit in years, (F) the unit development cost, that is, cost of development exclusive of depreciation and depletion, and (G) the unit operating cost, that is, cost of production exclusive of depreciation and depletion. In order to estimate the total operating profit for mines it is necessary to determine the quantity, quality, and recoverable mineral content of the developed, probable, and prospective ore reserves in all cases. For mines with a prior operating record the "spread of profit" per unit of recoverable mineral, or the percentage of net profit to gross proceeds from mineral production is the other factor required in estimates of the total expected profit. For mines with no prior operating record the future sales price and future production cost per unit of mineral must be estimated in order to determine the "spread of profit" per unit of recoverable mineral.

(*c*) If the deposit has been sufficiently developed the valuation factors specified in paragraph (*b*) may be determined from past operating experience. In the application of factors derived from past experience full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, cost of development, production, interest rate, and selling price of the product marketed during the expected operating life of the mineral deposit. Mineral deposits for which these factors may not be determined with reasonable accuracy from past operating experience may also, with the approval of the Commissioner, be valued by the present value method; but the factors must be deduced from concurrent evidence, such as the general type of the deposit, the characteristics of the district in which it occurs, the habit of the mineral deposits in the property itself, the intensity of mineralization, the oil-gas ratio, the rate at which additional mineral has been disclosed by exploitation, the stage of the operating life of the property, and any other evidence tending to establish a reasonable estimate of the required factors.

(*d*) Mineral deposits of different grades, locations, and probable dates of extraction in a mineral property should be valued separately. The mineral content of a deposit shall be determined in accordance with article 23 (m)–9. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases or decreases as indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or reasonably to be expected for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at the rate determined as above. The operating life of oil and gas wells is influenced by the natural decline in pressure and flow, and also by voluntary or enforced curtailment of production. The operating cost includes all current expense of producing, preparing, and marketing the mineral product sold (due consideration being given to taxes) exclusive of allowable capital additions as defined in article 23 (m)-15 and 23 (m)-16 and deductions for depreciation and depletion, but including cost of repairs. For definitions of "development expenses" and "operating expenses" in the case of oil and gas wells, see article 23 (m)-16. This cost of repairs is not to be confused with the depreciation deduction by which the cost or value of plant and equipment is returned to the taxpayer free from tax. In general, no estimates of these factors will be approved by the Commissioner which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods.

(*e*) The number of units of mineral recoverable in marketable form multiplied by the estimated operating profit per unit gives the total expected operating profit. The value of each mineral deposit is, then, the total expected operating profit from that deposit reduced to a present value as of the date as of which the valuation is made at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at that date of the depreciable assets and of the capital additions, if any, necessary to realize the profits. The degree of risk is generally lowest in cases where the factors of valuation are fully supported by the operating record of the mineral property prior to the date as of which the valuation is made; relatively higher risks attach to appraisals upon any other basis.

(*f*) For the purpose of the equitable apportionment of depletion between lessor and lessee provided by section 23 (m), when the value of any leased mineral property must be ascertained as of any specific date for the determination of the basis for depletion, the values of the equities of lessor and lessee may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the mineral property in fee simple.

ART. 23 (m)-8. *Revaluation of mineral deposits not allowed.*—No revaluation of a property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of a subsequent discovery of nonmetallic minerals, other than coal, sulphur, oil, or gas, as defined in article 23 (m)-14, or of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The value should, however, be corrected when a virtual change of ownership of part of the property results as the outcome of litigation. The value should be redistributed—

(*a*) If a revision of the number of remaining recoverable units of mineral in the property has been made in accordance with section 23 (m) and article 23 (m)-9, and

(*b*) In case of the sale of a part of the property, between the part sold and the part retained.

ART. 23 (m)-9. *Determination of mineral contents of mines and of oil or gas wells.*—If it is necessary to estimate or determine with respect to any property as of any specific date the total recoverable units (tons, pounds, ounces, barrels, thousands of cubic feet, or other measure) of mineral products reasonably known, or on good evidence believed, to have existed in the ground as of that date, the estimate or determination must be made according to the method current in the industry and in the light of the most accurate and reliable information obtainable. In the selection of a unit of estimate preference shall be given to the principal unit (or units) paid for in the product marketed. The estimate of the recoverable units of the mineral products in the property for the purposes of valuation and depletion shall include as to both quantity and grade—

(*a*) The ores and minerals "in sight," "blocked out," "developed," or "assured," in the usual or conventional meaning of these terms with respect to the type of the deposit, and

(*b*) "Probable" or "prospective" ores and minerals (in the corresponding sense), that is, ores and minerals that are believed to exist on the basis of good evidence although not actually known to occur on the basis of existing development; but "probable" or "prospective" ores and minerals may be estimated (1) as to quantity, only in case they are extensions of known deposits or are new bodies or masses whose existence is indicated by geological or other evidence to a high degree of probability, and (2) as to grade, only as accords with the best indications available as to richness.

If the number of recoverable units of mineral in the property have been previously estimated for the prior year or years, and if there has been no known change in the facts upon which the prior estimate was based, the number of recoverable units of mineral in the property as of the end of the taxable year will be the number remaining from the prior estimate, but when it is ascertained either by the taxpayer or the Commissioner as the result of operations or development work that the recoverable mineral units are materially greater or less than the prior estimate thereof, then such prior estimate shall be revised and the annual depletion allowance with respect to the property for subsequent taxable years will be based upon the revised estimate. Such revised estimate will not, however, affect the basis for depletion.

ART. 23 (m)-10. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(*a*) If a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the basis for depletion as provided in section 114 (b) (1) or (2) which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the lessor's basis for depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

(*b*) If the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, an amount equal to that part of the basis for depletion allocable to the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(*c*) If for any reason any such mineral lease expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

(*d*) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ percent of the amount thereof; and the lessors of sulphur mines, metal mines, and coal mines may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year beginning after December 31, 1937, for which he first makes return in respect of the property (and for subsequent taxable years in case an election to have depletion computed on a percentage basis has been exercised in the proper return) 23 percent, 15 percent, and 5 percent, respectively, of the amount thereof; but the deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property.

ART. 23 (m)-11. *Depletion and depreciation accounts on books.*—Every taxpayer claiming and making a deduction for depletion and depreciation of mineral property shall keep accurate accounts in which shall be recorded the cost or other basis provided by section 113 (a), as the case may be, of the mineral deposit and of the plant and equipment, together with subsequent allowable capital additions to each account and all of the other adjustments required by section 113 (b).

If the plan or method of depletion and depreciation accounting adopted by the taxpayer has once been approved by the Commissioner, it cannot be changed by the taxpayer without the consent of the Commissioner. These accounts shall thereafter be credited annually with the amounts of the depletion and depreciation computed in accordance with article 23 (m)-2, 23 (m)-3, 23 (m)-4, or 23 (m)-5; or the amounts of the depletion and depreciation so computed shall be credited to depletion and depreciation reserve accounts, to the end that when the sum of the credits for depletion and depreciation equals the cost or other basis of the property, plus subsequent allowable capital additions, no further deductions for depletion and depreciation with respect to the property shall be allowed, except such depletion deductions as may thereafter be allowable under section 114 (b) (2), (3), or (4) and article 23 (m)-3, 23 (m)-4, or 23 (m)-5.

Every taxpayer to whom section 114 (b) (2) and article 23 (m)-3 are applicable shall keep similar accounts with respect to discovery value.

ART. 23 (m)-12. *Statement to be attached to return when valuation, depletion, or depreciation of mineral property is claimed.*—(*a*) Except as provided in article 23 (m)-13, there shall be attached to the return of every taxpayer asserting a value for any mineral property as of a specific date or claiming a deduction for depletion or depreciation a statement setting forth with respect to each mineral property (including oil and gas property):

(1) The name, description, location, and identifying number, if any, of the property;

(2) Whether taxpayer is a fee owner, lessor, or lessee;

(3) The date of acquisition and, if under lease, the exact terms and date of expiration of the lease;

(4) The cost of the property, stating the amount paid to each vendor, with his name and address;

(5) The date as of which the property is valued, if a valuation is necessary to establish the basis as provided by section 113 (a);

(6) The value of the property on that date with a statement of the precise method by which it was determined;

(7) An allocation of the cost or value as between the mineral deposit and other assets such as plant, equipment, or the surface of the land for purposes other than mineral production;

(8) The estimated number of units of each kind of mineral at the end of the taxable year, and also at the date of acquisition, if acquired during the taxable year or at the date as of which any valuation is made, together with an explanation of the method used in the estimation, the name and address of the person making the estimate, and an average analysis which will indicate the quality of the mineral valued, including the grade or gravity in the case of oil;

(9) The number of units sold and the number of units for which payment was received during the year for which the return is made (in the case of newly developed oil and gas properties it is desirable that this information be furnished by month);

(10) The gross amount received from the sale of mineral;

(11) The amount of depreciation for the taxable year and the amount of depletion for the taxable year computed without reference to percentage depletion or discovery value;

(12) The amounts of depletion and depreciation, stated separately, which for each and every prior year (A) were allowed, (B) were allowable, and (C) would have been allowable without reference to percentage depletion or discovery value; and

(13) Any other data which will be helpful in determining the reasonableness of the valuation asserted or of the deduction claimed.

(*b*) To the return of every taxpayer claiming a deduction for depletion in respect of (1) property in which he owns a fractional interest only, or (2) a leasehold, or (3) property subject to lease, there shall also be attached a statement setting forth the fraction of the gross production to which the taxpayer is entitled, the name and address and the precise nature of the holding of each person interested in the property, and, in the case of a lessor, whether the lease involved was still in effect at the close of the taxable year, and, if not, when it was terminated and for what reason, and whether the lessor repossessed the property. Any taxpayer who is the assignor of a lease with respect to any property, or the holder of an interest purporting to be an overriding royalty interest, or of any interest other than that of a lessor or an operating lessee, and who claims depletion with respect to such property or interest, shall state the exact nature of the interest held and shall furnish a certified copy of the instrument or instruments by which it was acquired.

(*c*) In the case of oil and gas properties the statement attached to the return shall contain, in addition to the foregoing, the following information with respect to each property:

(1) The number of acres of producing oil or gas land and, if additional acreage is claimed to be proven, the amount of such acreage and the reasons for believing it to be proven;

(2) The number of wells producing at the beginning and end of the taxable year;

(3) The date of completion of wells finished during the taxable year;

(4) The date of abandonment of all wells abandoned during the taxable year;

(5) A property map showing the location of the property and of the producing and abandoned wells, dry holes, and proven oil and gas lands, the map should show depth, initial production, and date of completion of each well, to the extent that such data are available);

(6) The number of pay sands and average thickness of each pay sand or zone on the property;

(7) The average depth to the top of each of the different pay sands;

(8) Annual production of the tract or of the individual wells, if the latter information is available, from the beginning of its productivity to the end of the taxable year, the average number of wells producing during each year, and the initial daily production of each well (the extent to which oil or gas is used for fuel on the property should be stated with reasonable accuracy);

(9) All available data regarding change in operating conditions, such as unit operation, proration, flooding, use of air-gas lift, vacuum, shooting, etc., which have a direct effect on the production of the property; and

(10) Available geological information having a probable bearing on the oil and gas content; information with respect to edge-water, water drive, bottom hole pressures, oil-gas ratio, porosity of reservoir rock, percentage of recovery, expected date of cessation of natural flow, decline in estimated potential, and characteristics similar to characteristics of other known fields.

(*d*) All of the foregoing information must be furnished under oath, should be summarized, and may be included in a single affidavit.

(*e*) Any of the information required by this article which has been previously filed by the taxpayer need not be filed again but the statement attached to the return must indicate clearly when and in what form the information was previously filed. When a taxpayer has filed adequate maps with the Commissioner he may be relieved of filing further maps of the same properties, provided all additional information necessary for keeping the maps up to date is filed each year. This includes records of dry holes, as well as producing wells, together with logs, depth and thickness of sands, location of new wells, etc.

ART. 23 (m)-13. *Statement to be attached to return when depletion is claimed on percentage basis.*—(*a*) There shall be attached to the return of every taxpayer who claims depletion of oil and gas wells under section 114 (b) (3) and article 23 (m)-4, or depletion of coal mines, metal mines, or sulphur mines or deposits under section 114 (b) (4) and article 23 (m)-5, a statement containing the following information with respect to every property for which percentage depletion is allowable:

(1) All data necessary for the determination of the "gross income from the property" as defined in paragraph (*g*) of article 23 (m)-1, including the amounts paid to lessors as rents or royalties, the amounts paid to holders of other interests in the mineral property and the price per unit at which royalties were paid;

(2) All additional data necessary for the determination of the "net income of the taxpayer (computed without allowance for depletion) from the property" as defined in paragraph (*h*) of article 23 (m)-1; and

(3) The information required by paragraphs (*a*) (1), or (*a*) (2), (*a*) (3), and (*b*) of article 23 (m)-12. The other information required by article 23 (m)-12 shall also be furnished if necessary in determining the gain or loss from the sale or other disposition of the property during the taxable year or if a valuation of the property is necessary for any purpose. The taxpayer may find it desirable to furnish such information in all cases.

(*b*) All of the foregoing information shall be furnished under oath, should be summarized, and may be included in a single affidavit.

ART. 23 (m)-14. *Discovery of mines other than coal, metal, or sulphur mines.*—(*a*) To entitle a taypayer to a valuation of his property, for the purpose of depletion allowances, by reason of the discovery of a mine (other than a coal, metal, or sulphur mine) or minerals (other than oil or gas, coal, sulphur, metal, or metallic ores), it must appear that the mine or minerals were not acquired as the result of the purchase of a proven tract or lease; also, the discovery must be made by the taxpayer after February 28, 1913, and must result in the fair market value of the property becoming disproportionate to the cost. The fair market value of the property will be deemed to have become disproportionate to the cost when the newly discovered minerals are of such quantity and of such quality as to afford a reasonable expectation of return to the taxpayer of an amount materially in excess of the capital expended in making such discovery plus the cost of future development, equipment, and exploitation.

(*b*) A mine or minerals of a kind not excepted by this article may be said to be discovered when (1) there is found a natural deposit of mineral, or (2) there is disclosed by drilling or exploration, conducted above or below ground, a mineral deposit not previously known to exist and the existence of which was so improbable that such deposit had not and could not have been included in any previous valuation for the purpose of depletion, and which in either case exists in quantity and grades sufficient to justify commercial exploitation.

(*c*) In determining whether a discovery entitling the taxpayer to a valuation has been made, the Commissioner will take into account the peculiar conditions of each case; but no discovery, for the purposes of depletion, can be allowed as to minerals which constitute merely uninterrupted extensions of continuing commercial veins or deposits already known to exist, which have been or should have been included in "probable" or "prospective" mineral, or which were in any other way comprehended in a prior valuation, nor can a discovery, for purposes of depletion, be allowed as of a date subsequent to that when, in fact, discovery was evident, when delay by the taxpayer in making claim therefor has resulted or will result in excessive allowances for depletion.

(*d*) Discoveries include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, but such vein or deposit must not be merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and the newly discovered minerals must be of sufficient value and quantity that they could be separately mined and marketed at a profit.

(*e*) The value of property claimed as the result of a discovery must be the fair market value, as defined in article 23 (m)-7, based on what is evident within 30 days after the commercially valuable character and extent of the discovered deposits of mineral have with reasonable certainty been established, determined, or proved.

ART. 23 (m)-15. *Allowable capital additions in case of mines.*—(*a*) All expenditures in excess of net receipts from minerals sold shall be charged to capital account recoverable through depletion while the mine is in the development stage. The mine will be considered to have passed from a development to a producing status when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine becomes the production of developed ore rather than the development of additional ores for mining.

(*b*) Expenditures for plant and equipment and for replacements, not including expenditures for maintenance and for ordinary and necessary repairs, shall ordinarily be charged to capital account recoverable through depreciation. Expenditures for equipment (including its installation and housing) and for replacements thereof, which are necessary to maintain the normal output solely because of the recession of the working faces of the mine, and which (1) do not increase the value of the mine, or (2) do not decrease the cost of production of mineral units, or (3) do not represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made, shall be deducted as ordinary and necessary business expenses.

ART. 23 (m)-16. *Charges to capital and to expense in the case of oil and gas wells.*—(*a*) Items chargeable to capital or to expense at taxpayer's option:

(1) Option with respect to intangible drilling and development costs in general: All expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas, may, at the option of the taxpayer, be deducted from gross income as an expense or charged to capital account. Such expenditures have for convenience been termed intangible drilling and development costs. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, road making, surveying, and geological work as are necessary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Drilling and development costs shall not be excepted from the option merely because they are incurred under a contract providing for the drilling of a well to an agreed depth, or depths, at an agreed price per foot or other unit of measurement.

(2) Option with respect to cost of nonproductive wells: In addition to the foregoing option the cost of drilling nonproductive wells at the option of the taxpayer may be deducted from gross income for the year in which the taxpayer completes such a well or be charged to capital account returnable through depletion and depreciation as in the case of productive wells.

(3) If deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or if capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

(*b*) Recovery of optional items, if capitalized:

(1) Items returnable through depletion: If in exercising these options, or either of them, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized in so far as they are not represented by physical property, are returnable through depletion. For the purposes of this article the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(2) Items returnable through depreciation: If in exercising these options, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized, in so far as they are represented by physical property, are returnable through depreciation. Such expenditures are amounts paid for wages, fuel, repairs, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

(3) In the case of capitalized intangible drilling and development costs incurred under a contract, such costs shall be allocated between the foregoing classes of items for the purposes of determining the depletion and depreciation allowances.

(c) Nonoptional items distinguished:

(1) Capital items: The option with respect to intangible drilling and development costs in general does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the *actual materials* in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The options do not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are returnable through depreciation.

(2) Expense items: Expenditures which must be charged off as expense, regardless of the options provided by this article, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of oil or gas. General overhead expense, taxes, and depreciation of drilling equipment, are not considered as capital items, even when incurred during the development of the property.

(*d*) This article does not grant a new option or election. Any taxpayer who made an election or elections under article 223 of Regulations 69 or under article 243 of Regulations 74 or under article 236 of Regulations 77 or under article 23 (m)-16 of Regulations 86 or under article 23 (m)-16 of Regulations 94 is, by such election or elections, bound with respect to all optional expenditures whether made before January 1, 1938, or after December 31, 1937, in connection with oil and gas wells. Any taxpayer who has never made expenditures for drilling oil or gas wells prior to the first taxable year beginning after December 31, 1937, must make an election as to intangible drilling and development costs in general in the return for the first taxable year in which the taxpayer makes such expenditures, and a taxpayer who has never made expenditures for a nonproductive well prior to the first taxable year beginning after December 31, 1937, must make an election as to the cost of such wells in the return for the first taxable year in which the taxpayer completes such a well. Any election so made is binding for all subsequent years. A taxpayer is considered to have made an election in accordance with the manner in which the respective types of optional items are treated (1) in his return for the first taxable year ending after December 31, 1924, in which optional expenditures of the respective types are or were made, or (2) in an amended return filed between June 18, 1927, and December 18, 1927, in accordance with Treasury Decision 4025. Any taxpayer who has made expenditures for optional drilling and development costs must attach to his return for the first taxable year beginning after December 31, 1937, and for each year thereafter a clear statement of his election under each of the options, together with a statement of the time at which, and the manner in which, such election was made.

ART. 23 (m)-17. *Depreciation in the case of mines.*—(*a*) The Act provides that deductions for depreciation of improvements "according to the peculiar conditions in each case" may be taken by a taxpayer owning or leasing mining property. This is deemed to include exhaustion and wear and tear of the property used in mining of deposits, including a reasonable allowance for obsolescence. (See articles 23 (l)-1 to 23 (l)-10 as to deductions for depreciation and obsolescence generally. See particularly article 23 (l)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)

(*b*) It shall be optional with the taxpayer, subject to the approval of the Commissioner, whether the cost or other basis of the plant and equipment plus allowable capital additions but minus estimated salvage value shall be recovered (1) at a rate established by current exhaustion of mineral, or (2) by reasonable charges for depreciation (see article 23 (l)-1) at a rate determined by the physical life or the economic life of such plant and equipment, or, (3) according to the peculiar conditions of the case, by a method satisfactory to the Commissioner.

(*c*) The estimated physical life of a plant or unit thereof (including buildings, machinery, apparatus, roads, railroads, and other equipment and improvements whose principal use is in connection with the mining or treatment or other necessary handling of mineral products) may be defined as the estimated time such plant, or unit, when given proper care and repair, can be continued in use despite physical deterioration, decay, wear, and tear.

(*d*) The estimated economic life of a plant or unit thereof is the estimated time during which the plant or unit may be utilized effectively and economically for its intended purposes and may be limited by the life of the property or of that portion of the mineral deposits which it serves but can never exceed the physical life.

(*e*) Any difference between the salvage value of plant and equipment and the basis provided in section 113 (a), adjusted as provided in section 113 (b), remaining at the termination of mining operations shall be returned as profit or loss in the year in which it is realized.

(*f*) Nothing in these regulations shall be interpreted as meaning (1) that the cost or other basis of a mining plant and equipment may be reduced by depreciation deductions to a sum below the value of the salvage when the property shall have become obsolete or shall have been abandoned for the purpose of mining, or (2) that proper deductions for depreciation on account of obsolescence and decay shall not be made during periods when the mine is idle or is producing at a rate below its normal capacity. In estimating the salvage value of the equipment at the end of its estimated economic life due consideration may be given to its specialized character and the cost of dismounting and dismantling and transporting it to market.

(*g*) Nothing in these regulations shall be interpreted to permit expenditures charged to expense in any taxable year or any part of the value of land for purposes other than mining to be recovered through depletion or depreciation.

ART. 23 (m)-18. *Depreciation of improvements in the case of oil and gas wells.*—Both owners and lessees operating oil or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 23 (m)-16. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 23 (l)-1 to 23 (l)-10 as to deductions for depreciation and obsolescence generally. See particularly article 23 (l)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)

ART. 23 (m)-19. *Depletion and depreciation of oil and gas wells in years before 1916.*—If upon examination it is found that in respect of the entire drilling cost of wells, including physical property and incidental expenses, between March 1, 1913, and December 31, 1915, a taxpayer has been allowed a reasonable deduction sufficient to provide for the elements of exhaustion, wear and tear, and depletion, it will not be necessary to reopen the returns for years prior to 1916 in order to show separately in these years the portions of such deduction representing depletion and depreciation, respectively. Such separation will be required to be made of the reserves for depreciation at January 1, 1916, and proper allocation between depreciation and depletion must be maintained after that date.

ART. 23 (m)-20. *Capital recoverable through depletion allowance in the case of timber.*—In general, the capital remaining in any year recoverable through depletion allowances is the basis provided by section 113 (a) adjusted as provided by section 113 (b). For capitalization of carrying charges, see article 113 (b)-1. In the case of leases the apportionment of deductions between the lessor and lessee will be made as specified in article 23 (m)-7. The cost of timber properties shall be determined in accordance with the principles indicated in article 23 (m)-6. For method of determining fair market value and quantity of timber, see articles 23 (m)-25 to 23 (m)-27. For depletion purposes the cost of the timber shall not include any part of the cost of the land.

ART. 23 (m)-21. *Computation of allowance for depletion of timber for given year.*—The allowance for depletion of timber in any taxable year shall be based upon the number of units of timber felled during the year and the depletion unit of the timber in the timber account or accounts pertaining to the timber cut. The depletion unit of the timber for a given timber account in a given year shall be the quotient obtained by dividing (*a*) the basis, provided by section 113 (a) and adjusted as provided by section 113 (b), of the timber on hand at the beginning of the year plus the cost of the number of units acquired during the year plus proper additions to capital, by (*b*) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account. The amount of the deduction for depletion in any taxable year with respect to a given timber account shall be the product of the number of units of timber cut from the given account during the year multiplied by the depletion unit of the timber for the given account for the year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on a monthly basis, in which case the amount deductible on account of depletion for a given month will be determined in the manner outlined above for a given year. The total amount of the deduction for depletion in any taxable year shall be the sum of the amounts deductible for the several timber accounts. For description of timber accounts, see articles 23 (m)-27 and 23 (m)-28.

The depletion of timber takes place at the time the timber is felled. Since, however, it is not ordinarily practicable to determine the quantity of timber immediately after felling, depletion for purposes of accounting will be treated as taking place at the time when, in the process of exploitation, the quantity of timber felled is first definitely determined.

ART. 23 (m)-22. *Revaluation of timber not allowed.*—No revaluation of a timber property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The depletion unit should be changed when a revision of the remaining number of units of recoverable timber in the property has been made in accordance with article 23 (m)-26.

ART. 23 (m)-23. *Depreciation of improvements in the case of timber.*—The cost or other basis of development not represented by physical property having an inventory value shall be recoverable through depreciation. It shall be optional with the taxpayer, subject to the approval of the Commissioner—

(*a*) Whether the cost or other basis of the property subject to depreciation shall be recovered at a rate established by current exhaustion of stumpage, or

(*b*) Whether the cost or other basis shall be recovered by appropriate charges for depreciation calculated by the usual rules for depreciation or according to the peculiar conditions of the taxpayer's case by a method satisfactory to the Commissioner.

In no case may charges for depreciation be based on a rate which will extinguish the cost or other basis of the property prior to the termination of its useful life. Nothing in these regulations shall be interpreted to mean that the value of a timber plant and equipment may be reduced by depreciation deductions to a sum below the value of the salvage when the plant and equipment shall have become obsolete or worn out or shall have been abandoned, or that any part of the value of cut-over land may be recoverable through depreciation. (See articles 23 (l)-1 to 23 (l)-10 as to deductions for depreciation and obsolescence generally. See particularly article 23 (l)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)

ART. 23 (m)-24. *Information to be furnished by taxpayer claiming depletion of timber.*—To the income tax return of the taxpayer claiming a deduction for depletion or depreciation or both there shall be attached a map and statement (Form T—Timber) for the taxable year covered by the income tax return. Form T—Timber requires the following:

(*a*) Map showing timber and land acquired, timber cut, and timber and land sold;

(*b*) Description of, cost of, and terms of purchase or lease of, timber and land acquired;

(*c*) Proof of profit or loss from sale of capital assets;

(*d*) Description of timber with respect to which claim for loss, if any, is made;

(*e*) Record of timber cut;

(*f*) Changes in each timber account as the result of purchase, sale, cutting, reestimate, or loss;

(*g*) Changes in physical property accounts as the result of additions to or deductions from capital and depreciation;

(*h*) Operation data with respect to raw and finished material handled and inventoried;

(*i*) Unit production costs; and

(*j*) Any other data which will be helpful in determining the reasonableness of the depletion or depreciation deductions claimed in the return.

Similar information is required for certain years prior to the 1919 taxable year from those taxpayers who have not already furnished it. The specific nature of the information required for the earlier years is given in detail in Form T—General forest industries questionnaire for the years prior to 1919.

ART. 23 (m)-25. *Determination of fair market value of timber.*—If the fair market value of the property at a specified date is the basis for depletion and depreciation deductions, such value shall be determined, subject to approval or revision by the Commissioner upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, in methods of exploitation, in degree of utilization, etc. The value sought will be the selling price, assuming a transfer between a willing seller and a willing buyer, as of the particular date. Such factors as the following will be given due consideration:

(*a*) Character and quality of the timber as determined by species, age, size, condition, etc.;

(*b*) The quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber;

(*c*) Accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation, and the climate and the state of industrial development of the locality); and

(*d*) The freight rates by common carrier to important markets.

The timber in each particular case will be valued on its own merits and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned above, will be consistent with that of the other timber in the region. The Commissioner will give due weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares, royalties and rentals, value fixed by the owner for the purpose of the capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried or appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors. For depletion purposes the fair market value at a specified date shall not include any part of the value of the land.

For the purpose of the equitable apportionment of depletion between lessor and lessee provided by section 23 (m), when the value of any leased property must be ascertained as of any specific date for the determination of the basis for depletion, the values of the equities of lessor and lessee may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the property in fee simple.

ART. 23 (m)-26. *Determination of quantity of timber.*—Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, log scale, cords, or other units) of timber reasonably known, or on good evidence believed, to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, as the case may be. This estimate shall state as nearly as possible the number of units which would have been found present by a careful estimate made on the specified date with the object of determining 100 percent of the quantity of timber which the area would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return, as the result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work, it is ascertained either by the taxpayer or the Commissioner that there remain on the ground, available for utilization, more or less units of timber than remain in the timber account or accounts on the basis of the original estimate, then the original estimate (but not the basis for depletion) shall be revised and the annual depletion allowance with respect to the property for subsequent taxable years shall be based upon the revised estimate.

ART. 23 (m)-27. *Aggregating timber and land for purposes of valuation and accounting.*—With a view to logical and reasonable valuation of timber, the taxpayer shall include his timber in one or more accounts. In general, each such account shall include all of the taxpayer's timber which is located in one "block," a block being an operation unit which includes all of the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance, or in which the logs or other products will probably be sold in a log or other market, the block may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the Commissioner on audit, the taxpayer may divide the timber in a given block into two or more accounts, e. g., timber owned on February 28, 1913, and that purchased subsequently may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts, or individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts, or blocks may be divided into two or more accounts based on the character of the timber or its accessibility, or scattered tracts may be included in separate accounts. If such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

The timber accounts mentioned in the preceding paragraph shall not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in the foregoing part of this article the land in a given "block" may be carried in a single land account or may be divided into two or more accounts on the basis of its character or accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

The total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts, respectively.

Each of the several land and timber accounts carried on the books of the taxpayer shall be definitely described as to their location on the ground either by maps or by legal descriptions.

For good and substantial reasons satisfactory to the Commissioner, or as required by the Commissioner, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts.

ART. 23 (m)-28. *Timber depletion and depreciation accounts on books.*—Every taxpayer claiming or expecting to claim a deduction for depletion or depreciation of timber property (including plants, improvements, and equipment used in connection therewith) shall keep accurate ledger accounts in which shall be recorded the cost or other basis provided by section 113 (a), as the case may be, of the property, and the plants, improvements, and equipment, together with subsequent allowable capital additions to each account and all of the other adjustments provided by section 113 (b) and articles 113 (a) (14)-1, 113 (b)-1, 113 (b)-2, and 113 (b)-3.

In such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total cost or value shall be allocated to each. (See article 23 (m)-27.) These accounts shall be credited with the amount of the depreciation and depletion deductions computed in accordance with article 23 (m)-20 each year, or the amount of the depreciation and depletion shall be credited to depreciation and depletion reserve accounts, to the end that when the sum of the credits for depreciation and depletion equals the cost or other basis of the property, plus subsequent allowable capital additions, no further deduction for depreciation and depletion will be allowed.

[SEC. 23. *Deductions from gross income.*] [In computing net income there shall be allowed as deductions:]

(o) *Charitable and other contributions.*—In the case of an individual, contributions or gifts payment of which is made within the taxable year to or for the use of:

(1) the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes;

(2) a domestic corporation, or domestic trust, or domestic community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

(3) the special fund for vocational rehabilitation authorized by section 12 of the World War Veterans' Act, 1924;

(4) posts or organizations of war veterans, or auxiliary units or societies of any such posts or organizations, if such posts, organizations, units, or societies are organized in the United States or any of its possessions, and if no part of their net earnings inures to the benefit of any private shareholder or individual; or

(5) a domestic fraternal society, order, or association, operating under the lodge system, but only if such contributions or gifts are to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals;

to the amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this subsection. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary. (For unlimited deduction if contributions and gifts exceed 90 per centum of the net income, see section 120.)

ART. 23 (o)-1. *Contributions or gifts by individuals.*—A deduction is allowable under section 23 (o) only with respect to contributions or gifts which are actually paid during the taxable year, regardless of when pledged and regardless of the method of accounting employed by the taxpayer in keeping his books and records. A deduction is not allowable, however, for the actual payment of a contribution or gift if the amount of such payment already has been deducted on the accrual basis in computing net income for any taxable year beginning before January 1, 1938. A contribution or gift to a domestic organization described in section 23 (o) is deductible even though some portion of the funds of such organization is or may be used in foreign countries for charitable and educational purposes. This article does not apply to contributions or gifts by estates and trusts (see section 162).

No deduction is allowed in computing the net income of a common trust fund or a partnership for contributions or gifts made to organizations described in section 23 (o). (See sections 169 and 183.) However, a partner's proportionate share of contributions or gifts actually paid by a partnership during its taxable year to such organizations may be allowed as a deduction in his individual personal return for his taxable year with or within which the taxable year of the partnership ends, to an amount which, when added to the amount of contributions made by the partner individually and claimed as a deduction, is not in excess of 15 percent of his net income computed without the benefit of the deduction for contributions. In the case of a nonresident alien individual or a citizen of the United States entitled to the benefits of section 251, see sections 213 (c) and 251. For contributions or gifts by corporations, see article 23 (q)-1.

Whether a husband and wife make a joint return or separate returns, the 15 percent limitation on the deduction for contributions or gifts is based on the separate net income (computed without regard to such contributions or gifts) of the spouse making the contributions or gifts. (See article 51-1.)

A donation made by an individual to an organization other than one referred to in section 23 (o) which bears a direct relationship to his business and is made with a reasonable expectation of a financial return commensurate with the amount of the donation may constitute an allowable deduction as business expense.

Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses, are not deductible from gross income.

If the contribution or gift is other than money, the basis for calculation of the amount thereof shall be the fair market value of the property at the time of the contribution or gift.

In connection with claims for deductions under section 23 (o), there shall be stated in returns of income the name and address of each organization to which a contribution or gift was made and the amount and the approximate date of the actual payment of the contribution or gift in each case. Claims for deductions under section 23 (o) must be substantiated, when required by the Commissioner, by a statement from the organization to which the contribution or gift was made showing whether the organization is a domestic organization, the name and address of the contributor or donor, the amount of the contribution or gift and the date of the actual payment thereof, and by such other information as the Commissioner may deem necessary.

[SEC. 23. *Deductions from gross income.*] [In computing net income there shall be allowed as deductions:]

(p) *Pension trusts.*—(1) *General rule.*—An employer establishing or maintaining a pension trust to provide for the payment of reasonable pensions to his employees shall be allowed as a deduction (in addition to the contributions to such trust during the taxable year to cover the pension liability accruing during the year, allowed as a deduction under subsection (a) of this section) a reasonable amount transferred or paid into such trust during the taxable year in excess of such contributions, but only if such amount (1) has not theretofore been allowable as a deduction, and (2) is apportioned in equal parts over a period of ten consecutive years beginning with the year in which the transfer or payment is made.

(2) *Deductions under prior income tax acts.*—Any deduction allowable under section 23 (q) of the Revenue Act of 1928 or the Revenue Act of 1932 or the Revenue Act of 1934, or under section 23 (p) of the Revenue Act of 1936, which under such section was apportioned to any taxable year beginning after December 31, 1937, shall be allowed as a deduction in the years to which so apportioned to the extent allowable under such section if it had remained in force with respect to such year.

(3) *Exemption of trusts under section 165.*—The provisions of paragraphs (1) and (2) of this subsection shall be subject to the qualification that the deduction under either paragraph shall be allowable only with respect to a taxable year (whether the year of the transfer or payment or a subsequent year) of the employer ending within or with a taxable year of the trust with respect to which the trust is exempt from tax under section 165.

ART. 23 (p)-1. *Payments to employees' pension trusts.*—An employer who adopts or has adopted a reasonable pension plan, actuarily sound, and who establishes, or has established, and maintains a pension trust for the payment of reasonable pensions to his employees (if the trust is exempt from tax under section 165, relating to trusts created for the exclusive benefit of employees) shall be allowed to deduct from gross income reasonable amounts paid to such trust, in accordance with the pension plan (including any reasonable amendment thereof), as follows:

(*a*) If the plan contemplates the payment to the trust, in advance of the time when pensions are granted, of amounts to provide for future pension payments, then (1) reasonable amounts paid to the trust during the taxable year representing the pension liability applicable to such year, determined in accordance with the plan, shall be allowed as a deduction for such year as an ordinary and necessary business expense, and in addition (2) one-tenth of a reasonable amount transferred or paid to the trust during the taxable year to cover in whole or in part the pension liability applicable to the years prior to the taxable year, or so transferred or paid to place the trust on a sound financial basis, shall be allowed as a deduction for the taxable year and for each of the nine succeeding taxable years.

(*b*) If the plan does not contemplate the payment to the trust, in advance of the time when pensions are granted, of amounts to provide for future pension payments, then (1) reasonable amounts paid to the trust during the taxable year representing the present value of the expected future payments in respect of pensions granted to employees retired during the taxable year shall be allowed as a deduction for such year as an ordinary and necessary business expense, and in addition (2) one-tenth of a reasonable amount transferred or paid to the trust during the taxable year to cover in whole or in part the present value of the expected future payments in respect of pensions granted to employees retired prior to the taxable year, or so transferred or paid to place the trust on a sound financial basis, shall be allowed as a deduction for the taxable year and for each of the nine succeeding taxable years.

Deductions under section 23 (p) of the Revenue Act of 1938 or under a similar section of a prior Revenue Act and apportioned to any taxable year beginning after December 31, 1937, shall be allowable only with respect to a taxable year (whether the year of the transfer or payment or a subsequent year) of the employer which ends with or within a taxable year of the trust with respect to which the trust is exempt from tax under section 165. As to what constitutes an exempt employees' trust, see article 165-1.

If any portion of the funds of an exempt pension trust reverts to the possession, ownership, or control of the employer by reason of the termination of the trust or otherwise, such amount (except to the extent that it represents a payment to the pension trust made by the employer in accordance with the pension plan and pursuant to the first paragraph of this article, and not theretofore allowed as a deduction to the employer) shall be returned as income by the employer for the taxable year in which it so reverts, unless prior to the close of such year it shall again be placed in trust for the benefit of employees under provisions satisfactory to the Commissioner.

Reasonable payments made by an employer during the taxable year directly to pensioners on account of pensions in respect of which no payment has been made to a pension trust shall be allowed as a deduction from gross income for such year as an ordinary and necessary business expense.

In no case will any amount be allowed as a deduction under section 23 (p) and this article for the taxable year which was allowable as a deduction from gross income for any prior taxable year.

The application of section 23 (p) may be illustrated by the following examples:

Example (1)—Accruals in advance of pensions granted: In 1939 the M Company adopted a reasonable pension plan and established a pension trust which was exempt from tax under section 165. During the year and upon the basis of an actuarial computation the company paid $8,950,000 to the trust. At the time of the payment and in accordance with the pension plan of the company, the pension liability applicable to the years prior to 1939, in respect of employees then on the retired roll, for pensions to be paid in the future, was $2,000,000; the pension liability applicable to the years prior to 1939, in respect of employees on the active roll, for pensions to be paid in the future, was $6,500,000; the payment required to cover the pension liability applicable to the taxable year 1939 for pensions to be paid in the future, was $450,000. The amount paid to retired employees of the M Company by the pension trust as pensions during 1939 was $360,000.

The deduction for 1939 is computed as follows:

(*a*) Entire amount paid to pension trust representing the pension liability applicable to 1939 for pensions to be paid in the future	$450,000
(*b*) One-tenth of $8,500,000, amount transferred to pension trust to cover the pension liability applicable to the years prior to 1939, in respect of employees on either the retired roll or the active roll, for pensions to paid in the future	850,000
Total deduction	1,300,000

The amount of $360,000 paid to pensioners is not allowable as a deduction for income tax purposes since it was paid by the pension trust and not by the M Company.

Example (2)—Accruals on basis of pensions granted: In 1939 the N Company adopted a reasonable pension plan and established a pension trust which was exempt from tax under section 165. During the year and upon the basis of an actuarial computation the company paid $2,300,000 to the trust. At the time of the payment the present value of the expected future payments in respect of pensions granted to employees retired prior to 1939 was $2,000,000; the present value of the expected future payments in respect of pensions granted to employees retired during 1939 was $300,000. The amount paid to retired employees of the N Company by the pension trust as pensions during 1939 was $360,000.

The deduction for 1939 is computed as follows:

(*a*) Entire amount paid to the pension trust representing the present value of the expected future payments in respect of pensions granted to employees retired during 1939	$300,000
(*b*) One-tenth of $2,000,000, the amount transferred to the pension trust to cover the present value of the expected future payments in respect of pensions granted to employees retired prior to 1939	200,000
Total deduction	500,000

The amount of $360,000 paid to pensioners is not allowable as a deduction for income tax purposes, since it was paid by the pension trust and not by the N Company.

Example (3): In 1937 the Y Company adopted a reasonable pension plan and established a pension trust exempt from tax under section 165 of the Revenue Act of 1936 but which would not be exempt from tax for taxable years beginning after December 31, 1938, under section 165 of the Revenue Act of 1938. The Y Company and the trust make their income returns on a calendar year basis. On July 1, 1937, the Y Company pays $50,000 into the trust, for which under section 23 (p) of the Revenue Act of 1936 it is entitled to a deduction of $5,000 for each of the 10 consecutive years beginning with the calendar year 1937. On December 31, 1938, the Y Company makes all necessary changes in the trust so as to satisfy the requirements of section 165 of the Revenue Act of 1938. The Y Company is entitled to an annual deduction of $5,000 for the remaining portion of the 10-year period which began in 1937. If, however, the Y Company does not make the necessary changes so as to satisfy the requirements of section 165 of the Revenue Act of 1938 with respect to taxable years beginning after December 31, 1938, it is not entitled to any further deductions under section 23 (p). If it did not make such necessary changes until December 31, 1939, it is not entitled to a deduction of $5,000 for the year 1939 but is entitled to such annual deduction, however, for all subsequent taxable years up to and including the calendar year 1946.

ART. 23 (p)-2. *Information to be furnished by employer claiming deductions.*—If a deduction from gross income is claimed under section 23 (p) in an income return or in a claim for refund on account of payments to an employees' pension trust, the employer shall file with such return or claim for refund a statement describing the pension trust plan, including the basis and method of its operation, together with a copy of the trust indenture, with any amendments thereto, and other documents constituting a part of the plan. If all employees are not included as beneficiaries of the pension trust, a statement showing what classes of employees are excluded, and the general nature of their respective employment and duties, together with the reason why all employees are not covered by the pension trust plan, shall likewise be filed. If such statements have once been filed and if the return contains a statement when and where such statements were filed, they need not again be filed; but, however, if changes in the pension trust plan have been made, a statement showing the nature of such changes (together with copies of any amendments to the trust indenture and other documents constituting a part of the plan) must be filed with the return for the first taxable year for which allowance of deductions under section 23 (p) may be affected by such changes in the pension trust plan.

In addition the following described data and information shall be kept at all times available for inspection by internal revenue officers at the main office or principal place of business of the employer:

1. Schedules or work sheets showing the derivation of the basic valuation factors, or, if such data are not available, a statement giving the source of the factors from which the actuarial valuations were made.

2. (*a*) Schedules showing the computation of the reserve liability for all employees in the active service as determined from the most recent actuarial valuation. For taxable years beginning after December 31, 1937, the most recent actuarial valuation, for the purposes of this article, means such a valuation made not earlier than five years prior to the filing of the return.

(*b*) A similar schedule based on the next preceding valuation if such a valuation has been made.

3. A schedule showing by ages the individual current liability factors and the application of these factors in determining the liability accrued during the current taxable year.

4. (*a*) A schedule showing the computation of the pension liability for all employees retired on pension at the date of the last actuarial valuation.

(*b*) A schedule showing, by calendar years, the present value of pensions granted from the date of the last actuarial valuation to the end of the taxable year for which the deduction is claimed in an income return or in a claim for refund.

5. A schedule showing the receipts and disbursements of the pension fund during each taxable year carried forward from the date the pension trust was established. The receipts should include the accruals mentioned in paragraph 3, interest, and any other moneys credited to the fund. The disbursements should include actual pension payments made to retired employees and any other expenditures charged to the pension fund.

If the valuation factors are changed at any time, either because of a change in the pension plan or because of a change in the assumptions upon which the valuation factors are based, the data indicated under 2, 3, and 4 above should be available showing the application of both the old and the new valuation factors to the pay roll as of the valuation date coinciding with or next following the date of the change.

If the pension plan does not contemplate the payment to the trust in advance of the time when pensions are granted, of amounts to provide for future pension payments, the data described under 2 and 3 above need not be furnished.

[SEC. 23. *Deductions from gross income.*] [In computing net income there shall be allowed as deductions:]

(*q*) *Charitable and other contributions by corporations.*—In the case of a corporation, contributions or gifts payment of which is made within the taxable year to or for the use of a domestic corporation, or domestic trust, or domestic community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or the prevention of cruelty to children (but in the case of contributions or gifts to a trust, chest, fund, or foundation, only if such contributions or gifts are to be used within the United States exclusively for such purposes), no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation; to an amount which does not exceed 5 per centum of the taxpayer's net income as computed without the benefit of this subsection. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary.

(*r*) For deduction of dividends paid by certain banking corporations, see section 121.

ART. 23 (q)–1. *Contributions or gifts by corporations.*—A corporation may deduct from its gross income contributions or gifts to organizations described in section 23 (q), and to the extent provided by that section, only for the taxable year in which such contributions or gifts are actually paid, regardless of when pledged and regardless of the method of accounting employed by the corporation in keeping its books and records. As to charitable contributions by corporations not deductible under section 23 (a), see article 23 (a)–13. Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses are not deductible from gross income.

The provisions of the first paragraph of article 23 (o)–1, relating to (1) the statement in returns of the name and address of each organization to which a contribution or gift was made and the amount and the approximate date of the actual payment of the contribution or gift, (2) the substantiation of the claims for deductions when required by the Commissioner, and (3) the basis for calculation of the amount of a contribution or gift which is other than money, are equally applicable to claims for deductions of contributions or gifts by corporations under section 23 (q).

SEC. 24. *Items not deductible.*—(*a*) *General rule.*—In computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses;

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made;

(4) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy; or

(5) Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this title.

(*b*) *Losses from sales or exchanges of property.*—(1) *Losses disallowed.*—In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly—

(A) Between members of a family, as defined in paragraph (2) (D);

(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(C) Except in the case of distributions in liquidation, between two corporations more than 50 per centum in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either one of such corporations, with respect of the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;

(D) Between a grantor and a fiduciary of any trust;

(E) Between the fiduciary of a trust and the fiduciary of another trust, if the same person is a grantor with respect to each trust; or

(F) Between a fiduciary of a trust and a beneficiary of such trust.

(2) *Stock ownership, family, and partnership rule.*—For the purposes of determining, in applying paragraph (1), the ownership of stock—

(A) 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;

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

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

(D) 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

(E) *Constructive ownership as actual ownership.*—Stock constructively owned by a person by reason of the application of subparagraph (A) shall, for the purpose of applying subparagraph (A), (B), or (C), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of subparagraph (B) or (C) shall not be treated as owned by him for the purpose of again applying either of such subparagraphs in order to make another the constructive owner of such stock.

(*c*) *Unpaid expenses and interest.*—In computing net income no deduction shall be allowed under section 23 (a), relating to expenses incurred, or under section 23(b), relating to interest accrued—

(1) If such expenses or interest are not paid within the taxable year or within two

and one-half months after the close thereof; and

(2) If, 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 for the taxable year in which or with which the taxable year of the taxpayer ends; and

(3) If, at the close of the taxable year of the taxpayer or at any time within two and one-half months thereafter, both the taxpayer and the person to whom the payment is to be made are persons between whom losses would be disallowed under section 24 (b).

(d) *Holders of life or terminable interest.*—Amounts paid under the laws of any State, Territory, District of Columbia, possession of the United States, or foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time, nor by any deduction allowed by this Act (except the deductions provided for in subsections (l) and (m) of section 23) for the purpose of computing the net income of an estate or trust but not allowed under the laws of such State, Territory, District of Columbia, possession of the United States, or foreign country for the purpose of computing the income to which such holder is entitled.

(e) *Tax withheld on tax-free covenant bonds.*—For nondeductibility of tax withheld on tax-free covenant bonds, see section 143 (a) (3).

ART. 24-1. *Personal and family expenses.*—Insurance paid on a dwelling owned and occupied by a taxpayer is a personal expense and not deductible. Premiums paid for life insurance by the insured are not deductible. In the case of a professional man who rents a property for residential purposes, but incidentally receives clients, patients, or callers there in connection with his professional work (his place of business being elsewhere), no part of the rent is deductible as a business expense. If, however, he uses part of the house for his office, such portion of the rent as is properly attributable to such office is deductible. If the father is entitled to the services of his minor children, any allowances which he gives them, whether said to be in consideration of services or otherwise, are not allowable deductions in his return of income. Amounts paid as damages for breach of promise to marry, attorneys' fees and other costs of suit to recover such damages, attorneys' fees paid in a suit for separation, alimony, and an allowance paid under a separation agreement are not deductible from gross income. (See article 22 (b) (3)-1.) The cost of equipment of an Army officer to the extent only that it is especially required by his profession and does not merely take the place of articles required in civilian life is deductible. Accordingly, the cost of a sword is an allowable deduction, but the cost of a uniform is not.

ART. 24-2. *Capital expenditures.*—Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23 (l).) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities, when such commissions are not an ordinary and necessary business expense, are an offset against the selling price. Expenses of the administration of an estate, such as court costs, attorneys' fees, and executors' commissions, are chargeable against the corpus of the estate and are not allowable deductions. Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. (See article 22 (a)-17.) An assessment paid by a shareholder of a national bank on account of his statutory liability is ordinarily not deductible but, subject to the provisions of the Act, may in certain cases represent a loss. Expenses of the organization of a corporation, such as incorporation fees, attorneys' and accountants' charges, are capital expenditures and not deductible from gross income. A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary.

ART. 24-3. *Premiums on business insurance.*—Premiums paid by a taxpayer on an insurance policy on the life of an officer, employee, or other individual financially interested in the taxpayer's business, for the purpose of protecting the taxpayer from loss in the event of the death of the officer or employee insured are not deductible from the taxpayer's gross income. If, however, the taxpayer is not a beneficiary under such a policy, the premiums so paid will not be disallowed as deductions merely because the taxpayer may derive a benefit from the increased efficiency of the officer or employee insured. (See articles 22 (a)-3 and 23 (a)-6 to 23 (a)-9.) In either case the proceeds of such policies paid by reason of the death of the insured may be excluded from gross income whether the beneficiary is an individual or a corporation, provided the beneficiary is not a transferee of the policy for a valuable consideration. (See section 22 (b) (1) and (2) and article 22 (b) (1)-1.)

ART. 24-4. *Amounts allocable to exempt income, other than interest.*—(a) *Class of exempt income.*—As used in this article, the term "class of exempt income" means any class of income, other than interest (whether or not any amount of income of that class or classes is received or accrued), wholly exempt from the taxes imposed by Title I of the Act. Included are any item or class of income, other than interest, constitutionally exempt from the taxes imposed by Title I; any item or class, other than interest, excluded from gross income under any provision of section 22 or section 116 of the Act; and any item or class of income, other than interest, exempt under the provisions of any other law from the taxes imposed by Title I.

The object of section 24 (a) (5) is to segregate the exempt income from the taxable income, in order that a double exemption may not be obtained through the reduction of taxable income by expenses and other items incurred in the production of items of income wholly exempt from tax. Accordingly, just as exempt items of income are excluded from the computation of gross income under section 22, so this provision of the Act excludes from the computation of deductions under section 23 all items referable to the production of exempt income, other than exempt interest.

(b) *Determination of amounts allocable to a class of exempt income.*—No deduction may be allowed for the amount of any item or part thereof allocable to a class or classes of exempt income. Items, or parts of such items, directly attributable to any class or classes of exempt income, shall be allocated thereto; and items, or parts of such items, directly attributable to any class or classes of taxable income, shall be allocated thereto.

If an item is indirectly attributable both to taxable income and exempt income, a reasonable proportion thereof, determined in the light of all the facts and circumstances in each case, shall be allocated to each. Apportionments must in all cases be reasonable.

For example, if the compensation of an officer or employee of a State is immune from the Federal taxing power, such compensation is disregarded in computing the gross income of the officer or employee, and no deductions from gross income may be made for his expenses in performing the service for which the compensation is paid, or for State income taxes imposed on the compensation, or for losses or depreciation attributable to the property used in performing such service, or for any portion of overhead expenses so attributable.

(c) *Statement of items of exempt income—Records.*—A taxpayer receiving any class of exempt income or holding any property or engaging in any activity the income from which is exempt shall submit with his return as a part thereof an itemized statement, in detail, showing (1) the amount of each class of exempt income, and (2) the amount of items, or parts of items, allocated to each such class (the amount allocated by apportionment being shown separately) as required by paragraph (*b*). If an item is apportioned between a class of exempt income and a class of taxable income, the statement shall show the basis of the apportionment. Such statement shall also recite that each deduction claimed in the return is not in any way referable to exempt income. The taxpayer shall keep such records as will enable him to make the allocations required by this article (see section 54).

ART. 24-5. *Losses from sales or exchanges between certain classes of persons.*—(*a*) *Individuals (including fiduciaries).*—In the case of sales or exchanges of property, directly or indirectly, between individuals (including fiduciaries) section 24 (b) (1) provides that no deduction shall be allowed with respect to losses arising therefrom in the following cases: (1) between members of a family as defined in section 24 (b) (2) (D); (2) between fiduciaries of trusts having a common grantor; (3) between a grantor and a fiduciary of the same trust; or (4) between a fiduciary of a trust and a beneficiary of such trust.

(*b*) *Corporations (including shareholders).*—In the case of sales or exchanges of property (except in the case of distributions in liquidation) where a corporation not acting in a fiduciary capacity is a party to the transaction, section 24 (b) (1) also provides that under certain circumstances no deduction shall be allowed with respect to losses arising from such sales or exchanges, directly or indirectly, between a corporation and an individual shareholder (see section 24 (b) (1) (B)) or between two corporations (see section 24 (b) (1) (C)). Under section 24 (b) (1) (B) it is necessary that there be owned, directly or indirectly, by or for the individual a party to the transaction, more than 50 percent in value of the stock of the other party to the transaction on the date of the sale or exchange. Under section 24 (b) (1) (C), however, as provided therein, not only must more than 50 percent in value of the outstanding stock of each of such corporations be owned, directly or indirectly, on the date of the sale or exchange by or for the same individual, but one of the corporations must be either a personal holding company as defined in section 402, or a foreign personal holding company as defined in section 331, for the taxable year preceding the date of the sale or exchange. It is not necessary that either of the corporations be a personal holding company or a foreign personal holding company on the date of the sale or exchange.

(*c*) *Stock ownership rule.*—For the purpose of paragraph (*b*) of this article, the ownership of stock shall be determined in accordance with the rules provided in section 24 (b) (2). In order that an individual shall be considered under section 24 (b) (2) (C) as constructively owning the stock of a corporation owned, directly or indirectly, by or for his partner, such individual must himself own, directly or indirectly, stock of such corporation. On the other hand, under section 24 (b) (2) (B) an individual need not own any stock of a corporation, either directly or indirectly, in order to be considered as constructively owning the stock of such corporation which is owned, directly or indirectly, by or for any member of his family.

(*d*) *Illustrations of the application of section 24 (b).*—The application of section 24 (b) may be illustrated by the following examples:

Example (1): On July 1, 1938, the M Corporation owned all of the stock of the O Corporation which for the calendar year 1937 was a personal holding company under section 352 of Title IA of the Revenue Act of 1936, as amended by the Revenue Act of 1937. On that day all of the outstanding stock of the M Corporation was owned by A. By the application of the rule provided in section 24 (b) (2) (A), the stock in the O Corporation owned by the M Corporation is considered to be owned constructively by A, the sole stockholder of the M Corporation. Such constructive ownership of the stock of the O Corporation by A is considered as actual ownership for the purpose of applying the family rule provided in section 24 (b) (2) (B) to make a member of A's family, as, for example, his wife AW, the constructive owner of the stock of the O Corporation. But the constructive ownership of the O Corporation stock by AW may not be considered as actual ownership by AW for the purpose of again applying the family rule so as to make a member of AW's family, for example, her father, AWF, in turn constructive owner of such stock. These rules apply in the same manner and with the same effect in determining the ownership of stock in the M Corporation.

Accordingly, assuming that A, AW, AWF, the M Corporation and the O Corporation make their income returns on the basis of a calendar year and that there was no distribution in complete or partial liquidation of the M or O Corporation, no deduction is allowable under section 24 (b) (1) with respect to losses from sales or exchanges of property made on July 1, 1938, between any of such individuals or corporations, except as between A and AWF and between AWF and the M or O Corporation.

Example (2): On June 15, 1938, all of the stock of the N Corporation was owned in equal proportions by A and A's partner, AP. Except in the case of distributions in complete or partial liquidation by the N Corporation, no deduction is allowable with respect to losses from sales or exchanges of property made on June 15, 1938, between A and the N Corporation or AP and the N Corporation inasmuch as, by the application of section 24 (b) (2) (C), each partner is considered as having owned the stock owned by the other and, therefore, is considered as having owned more than 50 percent in value of the outstanding stock of the N Corporation. Deductions for losses from sales or exchanges between A's brother, AB, and the N Corporation, or between AP and A, or AP and AB are not prohibited by section 24 (b).

ART. 24-6. *Disallowance of deductions for unpaid expenses and interest.*—The application of section 24 (c) may be illustrated by the following example:

Example: A is the holder and owner of an interest-bearing note executed by the M Corporation all of the stock of which is owned by him. A and the M Corporation make their income returns on the basis of a calendar year but the M Corporation makes its returns on the accrual basis and A makes his returns on the cash receipts and disbursements basis. The M Corporation does not pay any interest on such note during the calendar year 1938 or within two and one-half months after the close thereof, but claims a deduction for the year 1938 with respect to the interest accruing on the note in that year. A, being on the cash receipts and disbursements basis, does not include such interest in his return for the year 1938. By the application of section 24 (c), no deduction for such interest is allowable in computing the net income of the M Corporation for the year 1938. The provisions of such section 24 (c) do not otherwise affect the general rules governing the allowance of deductions under the accrual basis. Hence, in the event the M Corporation should pay such interest after March 15, 1939, no deduction therefor would be allowable in computing its net income for the year in which the payment was made.

ART. 24-7. *Life or terminable interests.*—Amounts paid to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be subject to any deduction for shrinkage (whether called depreciation or any other name) in the value of such interest due to the lapse of time. In other words, the holder of such an interest so acquired may not set up the value of the expected future payments as corpus or principal and claim deductions for shrinkage or exhaustion thereof due to the passage of time. (See section 113 (a) (5).)

No deductions shall be allowed in the case of a life or terminable interest acquired by gift, bequest, or inheritance, if the estate or trust is entitled to a deduction under the Act but there is no reduction of the income of the life or terminable interest. For example, an estate or a trust in a certain State sells securities at a loss; if, under the laws of that State, the beneficiary suffers no actual loss, then even though the estate or trust is permitted to deduct such loss in making its return, the beneficiary whose income has not been diminished thereby is not entitled to a deduction on account of such loss, but must include in his return the full amount distributed or distributable. (See section 162.) However, in the case of property held by one person for life with remainder to another person and in the case of property held in trust, see section 23 (l) as to depreciation and section 23 (m) as to depletion.

CHAPTER V

Credits Against Income

SEC. 25. *Credits of individual against net income.*—(a) *Credits for normal tax only.*—There shall be allowed for the purpose of the normal tax, but not for the surtax, the following credits against the net income:

(1) *Interest on United States obligations.*—The amount received as interest upon obligations of the United States which is included in gross income under section 22.

(2) *Interest on obligations of instrumentalities of the United States.*—The amount received as interest on obligations of a corporation organized under Act of Congress, if (A) such corporation is an instrumentality of the United States; and (B) such interest is included in gross income under section 22; and (C) under the Act authorizing the issue thereof, as amended and supplemented, such interest is exempt from normal tax.

(3) *Earned income credit.*—10 per centum of the amount of the earned net income, but not in excess of 10 per centum of the amount of the net income.

(4) *Earned income definitions.*—For the purposes of this section—

(A) "Earned income" means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered, but does not include any amount not included in gross income, nor that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income producing factors, a reasonable allowance as compensation for the personal services actually rendered by the taxpayer, not in excess of 20 per centum of his share of the net profits of such trade or business, shall be considered as earned income.

(B) "Earned income deductions" means such deductions as are allowed by section 23 for the purpose of computing net income, and are properly allocable to or chargeable against earned income.

(C) "Earned net income" means the excess of the amount of the earned income over the sum of the earned income deductions. If the taxpayer's net income is not more than $3,000, his entire net income shall be considered to be earned net income, and if his net income is more than $3,000, his earned net income shall not be considered to be less than $3,000. In no case shall the earned net income be considered to be more than $14,000.

(b) *Credits for both normal tax and surtax.*—There shall be allowed for the purposes of the normal tax and the surtax the following credits against net income:

(1) *Personal exemption.*—In the case of a single person or a married person not living with husband or wife, a personal exemption of $1,000; or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,500. A husband and wife living together shall receive but one personal exemption. The amount of such personal exemption shall be $2,500. If such husband and wife make separate returns, the personal exemption may be taken by either or divided between them.

(2) *Credit for dependents.*—$400 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.

(3) *Change of status.*—If the status of the taxpayer, insofar as it affects the personal exemption or credit for dependents, changes during the taxable year, the personal exemption and credit shall be apportioned, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, in accordance with the number of months before and after such change. For the purpose of such apportionment a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

ART. 25-1. *Credits of individual against net income.*—For the purpose of computing the normal tax the taxpayer's net income as determined pursuant to sections 21-24 is first reduced by the sum of the allowable credits. These include interest exempt from normal tax only (and hence included in gross income) received upon (1) obligations of the United States and (2) obligations of corporations organized under Act of Congress which are instrumentalities of the United States; an earned income credit; a personal exemption; and a credit for dependents. (See section 22 (b) (4).) For the purpose of computing the surtax the taxpayer's net income is entitled to none of these credits, except the credit for personal exemption and credit for dependents.

ART. 25-2. *Earned income credit.*—Under section 25 (a) (3) the earned income credit allowable for the purpose of computing the normal tax is 10 percent of the amount of the earned net income, but not in excess of 10 percent of the amount of the entire net income.

The entire amount received as professional fees may be treated as earned income if the taxpayer is engaged in a professional occupation, such as a doctor or a lawyer, even though he employs assistants to perform part or all of the services, provided the clients or patients are those of the taxpayer and look to the taxpayer as the person responsible for the services performed. In the case of a husband and wife domiciled in a so-called community property State and rendering separate income tax returns on the community income basis, one-half of the income derived from personal services rendered by one spouse may be treated as earned income in the separate return of the other spouse.

In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the taxpayer shall be considered earned income, but the total amount which shall be treated as the earned income of the taxpayer from such a trade or business shall, in no case, exceed 20 percent of his share of the net profits of such trade or business. No general rule can be prescribed defining the trades or businesses in which personal services and capital are material income-producing factors, but this question must be determined with respect to the facts of the individual cases.

The provisions of sections 25 (a) (3) and 25 (a) (4) may be illustrated generally by the following examples:

Example (1): An individual received income from interest on bonds during the calendar year 1938 amounting to $6,000. His allowable deductions under section 23 for that year amounted to $2,000. He is entitled to an earned income credit of $300, computed as follows:

Gross income	$6,000
Allowable deductions	2,000
Entire net income	4,000
Earned net income allowable under section 25 (a) (4) (C)	3,000
Earned income credit allowable (10 percent of $3,000)	300

Example (2): An individual received a salary of $20,000 as a traveling salesman for the calendar year 1938. His allowable deductions under section 23 for that year amounted to $12,000, of which $2,000 was for traveling expenses in the course of his business and $10,000 was for a loss of his home from fire. His net income is $20,000 minus $12,000, or $8,000. He is entitled to an earned income credit of $800, computed as follows:

Earned income	$20,000
Earned income deductions	2,000
Earned net income before applying limitation in section 25 (a) (4) (C)	18,000
Earned net income as limited to maximum amount prescribed by section 25 (a) (4) (C)	14,000
Earned income credit before applying limitation in section 25 (a) (3) (10 percent of $14,000)	1,400
Earned income credit allowable as limited by section 25 (a) (3) (10 percent of $8,000, net income)	800

Example 3: During the calendar year 1938 an individual was engaged in a business in which both personal services and capital were income-producing factors. A reasonable allowance as compensation for the personal services actually rendered by the taxpayer in the conduct of the business for that year was $10,000. The net profits of the business were $35,000, which constituted his net income for the year. He is entitled to an earned income credit of $700, computed as follows:

Earned income before applying limitation in section 25 (a) (4) (A)	$10,000
Earned income as limited by section 25 (a) (4) (A) (20 percent of $35,000)	7,000

Earned income credit allowable (10 percent of $7,000)	700

ART. 25-3. *Amount of personal exemption allowable.*—A single person or a married person not living with husband or wife is entitled to a personal exemption of $1,000 and the head of a family or a married person living with husband or wife to $2,500, regardless of the amount of the net income. A husband and wife living together have but one personal exemption, which is $2,500. If they make separate returns, each may claim one-half of the personal exemption, or such exemption may, in accordance with an agreement entered into by them, be taken by either or divided between them in any proportion.

ART. 25-4. *Personal exemption of head of family.*—A head of a family is an individual who actually supports and maintains in one household one or more individuals who are closely connected with him by blood relationship, relationship by marriage, or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation. In the absence of continuous actual residence together, whether or not a person with dependent relatives is a head of a family within the meaning of the Act must depend on the character of the separation. If a father is absent on business, or a child or other dependent is away at school or on a visit, the common home being still maintained, the additional exemption applies. If, moreover, through force of circumstances a parent is obliged to maintain his dependent children with relatives or in a boarding house while he lives elsewhere, the additional exemption may still apply. If, however, without necessity the dependent continuously makes his home elsewhere, his benefactor is not the head of a family, irrespective of the question of support. A resident alien with children abroad is not thereby entitled to credit as the head of a family. As to the amount of the exemption, see article 25-3.

ART. 25-5. *Personal exemption of married person.*—In the case of a married man or married woman the joint exemption replaces the individual exemption only if the man lives with his wife or the woman lives with her husband. In the absence of continuous actual residence together, whether or not a man or woman has a wife or husband living with him or her within the meaning of the Act must depend on the character of the separation. If merely occasionally and temporarily a wife is away on a visit or a husband is away on business, the joint home being maintained, the additional exemption applies. The unavoidable absence of a wife or husband at a sanatorium or asylum on account of illness does not preclude claiming the exemption. If, however, the husband voluntarily and continuously makes his home at one place and the wife hers at another, they are not living together within the meaning of the Act, irrespective of their personal relations. A resident alien with a wife residing abroad is not entitled to the joint exemption.

ART. 25-6. *Credit for dependents.*—A taxpayer, other than a nonresident alien who is not a resident of Canada or Mexico (see section 214), receives a credit of $400 for each person (other than husband or wife), whether related to him or not and whether living with him or not, dependent upon and receiving his chief support from the taxpayer, provided the dependent is either (*a*) under 18, or (*b*) incapable of self-support because defective.

The credit is based upon actual financial dependency and not mere legal dependency. It may accrue to a taxpayer who is not the head of a family. But a father whose children receive half or more of their support from a trust fund or other separate source is not entitled to the credit.

ART. 25-7. *Personal exemption and credit for dependents where status changes.*—If the status of the taxpayer changes during the taxable year, the personal exemption allowed by section 25 (b) (1) to a single person, a married person not living with husband or wife, a head of a family, or a married person living with husband or wife, and the credit for dependents allowed by section 25 (b) (2) will be apportioned according to the number of months during which the taxpayer occupied each status. A taxpayer not having the status of a head of a family or the status of a married person living with husband or wife shall be considered as having the status of a single person. For the purpose of the apportionment of the personal exemption and credit for dependents a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month. In general, the personal exemption and credit for dependents allowable to any taxpayer will be the sum of the amounts apportioned to the several periods of the taxable year during which each status was occupied.

Example (1): A, who had been single during the preceding months of 1938, married B on July 20 and lived with her during the remainder of the year. If a joint return is made by A and B on the calendar year basis for 1938, the personal exemption will be $2,208.33; that is, $\frac{7}{12}$ of $1,000 for A while single, plus $\frac{7}{12}$ of $1,000 for B while single, plus $\frac{5}{12}$ of $2,500 for the period during which they were married. If separate returns are made by A and B on the calendar year basis for 1938, each may claim a personal exemption of $1,104.17; that is, $\frac{7}{12}$ of $1,000, plus $\frac{1}{2}$ of $\frac{5}{12}$ of $2,500. In the latter case, however, the joint exemption of $\frac{5}{12}$ of $2,500 may by agreement be taken either by A or B or divided between them in any proportion.

Example (2): A and B, who were heads of families during the first six months of 1938, were married on July 1, 1938, and lived together during the remainder of the year. If a joint return is made by A and B on the calendar year basis for 1938, the personal exemption will be $3,750; that is, $\frac{1}{2}$ of $2,500 for A while the head of a family, plus $\frac{1}{2}$ of $2,500 for B while the head of a family, plus $\frac{1}{2}$ of $2,500 for the period during which they were married and living together. If separate returns are made by A and B on the calendar year basis for 1938, each may claim a personal exemption of $1,875; that is, $\frac{1}{2}$ of $2,500, plus $\frac{1}{2}$ of $\frac{1}{2}$ of $2,500. In the latter case, however, the joint exemption of $\frac{1}{2}$ of $2,500 may by agreement be taken either by A or B or divided between them in any proportion.

Example (3): A and B were married and living together until November 30, 1938, when B, the wife, died. They had no dependents. The executor or administrator in making a return for B may claim a personal exemption of $1,229.16; that is, $\frac{1}{2}$ of $\frac{11}{12}$ of $2,500, or $1,145.83, for the period from the beginning of the taxable year to the date of the decedent's death, plus $\frac{1}{12}$ of $1,000, or $83.33, for the period from the date of the decedent's death to the close of the taxable year. If A, the surviving spouse, makes a return for 1938 on the calendar year basis, he may claim a personal exemption of $1,229.16; that is, $\frac{1}{2}$ of $\frac{11}{12}$ of $2,500, or $1,145.83, plus $\frac{1}{12}$ of $1,000, or $83.33. However, the combined personal exemption of A and B for the period during which they were married and living together, that is, $\frac{11}{12}$ of $2,500, or $2,291.67, may by agreement be taken either by A, or by B's executor or administrator in behalf of B, or divided between them in any proportion.

Example (4): A furnished the chief support of a child under 18 years of age until the death of the child on June 20, 1938. If A makes a return on the calendar year basis for 1938, he is entitled, in addition to the personal exemption allowed under section 25 (b) (1), to a credit for dependents in the amount of $200; that is, $\frac{6}{12}$ of $400.

Example (5): A and B were married and living together until June 30, 1938, when A, the husband, died. Prior to the date of death, A was the chief support of a child 10 years of age. B, the surviving spouse, was the chief support of the child during the remainder of the year. If B makes a return for 1938 on the calendar year basis, she is entitled, in addition to a personal exemption, to a credit for dependents in the amount of $200; that is, $\frac{6}{12}$ of $400. The executor or administrator in making a return for A is entitled, in addition to a personal exemption, to a credit for dependents in the amount of $200; that is, $\frac{6}{12}$ of $400.

SEC. 26. *Credits of corporations.*—In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

(*a*) *Interest on obligations of the United States and its instrumentalities.*—The amount received as interest upon obligations of the United States or of corporations organized under Act of Congress which is allowed to an individual as a credit for purposes of normal tax by section 25 (a) (1) or (2).

(*b*) *Dividends received.*—85 per centum of the amount received as dividends from a domestic corporation which is subject to taxation under this title, but not in excess of 85 per centum of the adjusted net income. The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, or from a corporation which under section 251 is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States.

(*c*) *Net operating loss of preceding year.*—(1) *Amount of credit.*—The amount of the net operating loss (as defined in paragraph (2)) of the corporation for the preceding taxable year, but not in excess of the adjusted net income for the taxable year.

(2) *Definition.*—As used in this title the term "net operating loss" means the excess of the deductions allowed by this title over the gross income, with the following exceptions and limitations—

(A) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114 (b) (2), (3), or (4);

(B) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this title, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations.

(*d*) *Bank affiliates.*—In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount of the earnings or profits which the Board of Governors of the Federal Reserve System certifies to the Commissioner has been devoted by such affiliate during the taxable year to the acquisition of readily marketable assets other than bank stock in compliance with section 5144 of the Revised Statutes. The aggregate of the credits allowable under this subsection for all taxable years beginning after December 31, 1935, shall not exceed the amount required to be devoted under such section 5144 to such purposes, and the amount of the credit for any taxable year shall not exceed the adjusted net income for such year.

(*e*) *Dividends paid credit.*—For corporation dividends paid credit, see section 27.

(*f*) *Consent dividends credit.*—For corporation consent dividends credit, see section 28.

ART. 26–1. *Credit of corporation for interest on obligations of the United States and its instrumentalities.*—The credit allowed by section 26 (a) is an amount equal to the interest received upon obligations of the United States or of a corporation organized under Act of Congress (if such corporation is an instrumentality of the United States and under the Act authorizing the issue of such obligations, as amended and supplemented, such interest is in the case of individuals exempt from normal tax) which is included in gross income under section 22.

ART. 26–2. *Credit of corporation for net operating loss of preceding year.*—Since the net operating loss credit allowed by section 26 (c) cannot exceed the adjusted net income for the taxable year, it is the smaller of the following amounts:

(*a*) The excess of the deductions allowed by Title I for the preceding taxable year over gross income for such year, both computed in accordance with the exceptions and limitations provided by section 26 (c) (2).

(*b*) The adjusted net income for the taxable year, i. e., the net income minus the credit provided by section 26 (a) (see section 13 (a)).

In computing deductions for the preceding taxable year any deduction for depletion shall be computed without reference to discovery value or percentage depletion under section 114 (b) (2), (3), or (4) (see article 23 (m)–2). The basis for such depletion is the basis provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain upon the sale or other disposition of the property involved.

In computing the gross income for the preceding taxable year there must be included the excess, if any, of the amount of any interest received which is wholly exempt from taxes imposed by Title I over the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations.

Example: For 1939 the X Corporation, which makes its income tax returns on the calendar year basis, has a net income of $10,000, included in which is $2,000 of interest on United States obligations allowed as a credit under section 26 (a). For 1938 its gross income was $5,000, and its allowable deductions were $10,000. Included in such deductions was $3,000 for depletion based on discovery value. If depletion had been computed without reference to discovery value or to percentage depletion the amount of such deduction would have been $1,000. For 1938 the corporation had $3,000 of wholly tax-exempt interest, and paid $2,000 in interest on indebtedness incurred to carry the obligations from which such tax-exempt interest was derived. The net operating loss credit available to such corporation for 1939 is $2,000, computed as follows:

Deductions for 1938	$10,000	
Less excess of depletion deduction computed on basis of discovery value over amount allowable for depletion without reference to discovery value or percentage depletion ($3,000—$1,000)	2,000	
Deductions as limited by section 26 (c) (2) (A)		$8,000
Gross income for 1938	$5,000	
Plus tax-exempt interest minus interest paid ($3,000—$2,000)	1,000	
Gross income contemplated by section 26 (c) (2) (B)		6,000
Excess of deductions over gross income for 1938		2,000
Net income for 1939		10,000
Less credit under section 26 (a) for interest received		2,000
Adjusted net income for 1939		8,000

The net operating loss credit is $2,000, that amount not being in excess of the adjusted net income for 1939.

ART. 26–3. *Bank affiliates.*—The credit provided in section 26 (d) is allowed—

(1) to a holding company affiliate of a bank, as defined in section 2 of the Banking Act of 1933, which holding company affiliate holds, at the end of the taxable year, a general voting permit granted by the Board of Governors of the Federal Reserve System;

(2) in the amount of the earnings or profits of such holding company affiliate which, in compliance with section 5144 of the Revised Statutes, has been devoted by it during the taxable year to the acquisition of readily marketable assets other than bank stock;

(3) upon certification by the Board of Governors of the Federal Reserve System to the Commissioner that such an amount of the earnings or profits has been so devoted by such affiliate during the taxable year.

No credit is allowable under section 26 (d) for the amount of readily marketable assets acquired and on hand at the beginning of the first taxable year subject to the Revenue Act of 1938, whether or not a credit was allowed for all or part of such amount under section 26 (d) of the Revenue Act of 1936, or for an amount of readily marketable assets in excess of what is required by such section 5144 to be acquired by such affiliate, or in excess of the adjusted net income for the taxable year. Nor may the aggregate of the credits allowable under section 26 (d) of the Revenue Acts of 1936 and 1938 exceed the amount required to be devoted under section 5144 to the acquisition of readily marketable assets other than bank stock.

Every taxpayer claiming and making a deduction for the credit provided for in section 26 (d) shall attach to its return a supplementary statement, in duplicate, setting forth all the facts and information upon which the claim is predicated, including such facts and information as the Board of Governors of the Federal Reserve System may prescribe as necessary to enable it, upon the request of the Commissioner subsequent to the filing of the return, to certify to the Commissioner the amount of earnings or profits devoted to the acquisition of such readily marketable assets. A certified copy of such supplementary statement shall be forwarded by the taxpayer to the Board of Governors at the time of the filing of the return. The holding company affiliate shall also furnish the Board of Governors such further information as the Board shall require. For the requirements with respect to the amount of such readily marketable assets which must be acquired and maintained by a holding company affiliate to which a voting permit has been granted, see subsections (b) and (c) of section 5144 of the Revised Statutes (paragraph 64 of the Appendix to these regulations).

SEC. 27. *Corporation dividends paid credit.*—(*a*) *Definition in general.*—As used in this title with respect to any taxable year the term "dividends paid credit" means the sum of:

(1) The basic surtax credit for such year, computed as provided in subsection (b);

(2) The dividend carry-over to such year, computed as provided in subsection (c);

(3) The amount, if any, by which any deficit in the accumulated earnings and profits, as of the close of the preceding taxable year (whether beginning on, before, or after January 1, 1938), exceeds the amount of the credit provided in section 26 (c) (relating to net operating losses), for such preceding taxable year (if beginning after December 31, 1937); and

(4) Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind, if such amounts are reasonable with respect to the size and terms of such indebtedness. As used in this paragraph the term "indebtedness" means only an indebtedness of the corporation existing at the close of business on December 31, 1937, and evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the corporation and in existence at the close of business on December 31, 1937, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on such date. Where the indebtedness is for a principal sum, with interest, no credit shall be allowed under this paragraph for amounts used or set aside to pay such interest.

ART. 27 (a)-1. *Dividends paid credit.*—The amount of the dividends paid credit provided by section 27 (a) is an amount equivalent to the sum of the following:

(1) The basic surtax credit for the taxable year. For computation of the basic surtax credit see section 27 (b).

(2) The dividend carry-over to the taxable year. For computation of the dividend carry-over see section 27 (c).

(3) The deficit credit provided by section 27 (a) (3).

(4) Amounts used or irrevocably set aside to pay or to retire indebtedness as provided in section 27 (a) (4).

ART. 27 (a)-2. *Deficit credit.*—Included in the dividends paid credit is an amount equal to the excess of any deficit in accumulated earnings and profits as of the close of the preceding taxable year (whether beginning on, before, or after January 1, 1938) over the net operating loss credit allowed by section 26 (c) for such preceding taxable year (if beginning after December 31, 1937). The full amount of such deficit is includible in computing the dividends paid credit for the first taxable year beginning after December 31, 1937, since no net operating loss credit will be available until the second taxable year subject to the Act.

A deficit in accumulated earnings and profits can arise only out of the operation of the business at a loss and cannot be caused by distributions to shareholders in excess of the amount of accumulated earnings and profits. If distributions are made to shareholders out of accumulated earnings and profits, however, such distributions may contribute to the creation of a deficit by so exhausting the accumulated earnings and profits that they are incapable of absorbing a loss thereafter resulting from the business. It is the subsequent operating loss, however, and not the distribution which creates the deficit. For example, the X Corporation, which makes its income tax returns on the calendar year basis, has on January 1, 1938, accumulated earnings and profits of $100,000. During 1938 there are no further earnings and profits. On February 1, 1938, operating losses have reduced the accumulated earnings and profits account to $50,000. On March 1, 1938, $90,000 is distributed to shareholders. On April 1, 1938, an operating loss of $40,000 is incurred. There is no further change during the taxable year. Though the corporation closes its year with total assets of $180,000 less than it had on January 1, 1938, and $90,000 of that amount was attributable to operating losses, only $40,000 constitutes a deficit in accumulated earnings and profits as of the close of the year. If, however, no operating losses were incurred up to February 1, $90,000 was distributed to shareholders on February 1, a $50,000 operating loss was incurred on March 1, and a $40,000 operating loss on April 1, the corporation's deficit in accumulated earnings and profits would be $80,000 as of the close of the year.

ART. 27 (a)-3. *Amounts used or irrevocably set aside to pay or to retire indebtedness*—(*a*) *Indebtedness.*—The term "indebtedness" means an obligation of the corporation, absolute and not contingent, to pay, on demand or within a given time, in cash or other medium, a fixed amount, existing at the close of business on December 31, 1937, and evidenced at the time payment is made or amounts are irrevocably set aside by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the corporation and in existence at the close of business on December 31, 1937, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on December 31, 1937. The mere substitution, after December 31, 1937, of several instruments for one instrument, or one instrument for several instruments, existing at the close of business on such date, where there is no change in terms except the substitution of a series of different amounts equal in the aggregate to the total principal amount of the instrument or instruments surrendered (as, for example, where two $50,000 bonds are issued in exchange for one $100,000 bond, or where one $100,000 bond is issued in exchange for two $50,000 bonds), or the reissue of a lost or destroyed instrument, or the issue of a new instrument to a transferee, will not deprive a corporation of the benefits of section 27 (a) (4).

Double credits are not permitted, either for the same year or for separate years. Thus, amounts which have been or may be properly taken as a credit pursuant to section 27 (e) of the Act or section 27 (d) of the Revenue Act of 1936 (both sections relating to dividends in obligations of the corporation) may not again be included in the dividends paid credit under section 27 (a) (4) when the obligations are paid. No credit may be allowed under section 27 (a) (4) for amounts used or irrevocably set aside to pay or retire indebtedness which represents an item which is allowable as a deduction from gross income, either for the same year or a different year. Thus the aggregate of the credits allowable under section 27 (a) (4) for amounts used or irrevocably set aside to pay or to retire obligations issued at a discount may not exceed the issue price of such obligations.

The credit provided by section 27 (a) (4) extends only to amounts used or irrevocably set aside to pay or to retire the principal of indebtedness evidenced by the types of obligations enumerated in that section. The denial of a credit for amounts used or set aside to discharge an obligation to pay interest applies whether the interest involved became due on, before, or after January 1, 1938. If interest is allowable as a deduction under section 23 (b) or a corresponding section of a prior income tax law when paid or accrued or would be so allowable if it were not for the exception contained in such section or section 24 (c), no credit will be allowed under section 27 (a) (4) with respect to such interest, despite the fact that such interest may have been funded and forms part or all of the principal amount of an obligation of the character described in section 27 (a) (4).

Indebtedness incurred through the assumption of the liabilities of another is not indebtedness within the meaning of section 27 (a) (4), even though such assumption took place prior to January 1, 1938, unless evidenced by one or more of the instruments enumerated in such section, issued by the taxpayer prior to, and in existence at, the close of business on December 31, 1937. Similarly, indebtedness represented by a renewal obligation issued after December 31, 1937, will not be classed as indebtedness for the purposes of section 27 (a) (4).

(*b*) *Amounts used or irrevocably set aside.*—The credit is allowable, in any taxable year, only for amounts used or *irrevocably* set aside in that year. The use or irrevocable setting aside must be to effect the extinguishment or discharge of indebtedness. The issuance of a renewal obligation will, therefore, not result in an allowable credit. If amounts are set aside in one year, no credit is allowable for such amounts for a later year in which actually paid. As long as all other conditions are satisfied, the aggregate amount allowable as a credit for any taxable year includes all amounts (from whatever source) used and, as well, all amounts (from whatever source) *irrevocably* set aside, irrespective of whether in cash or other medium. Double credits are not permitted.

(c) *Reasonableness of the amounts with reference to the size and terms of the indebtedness.*—The reasonableness of the amounts used or *irrevocably* set aside must be determined by reference to the size and terms of the particular indebtedness. Hence, all the facts and circumstances with respect to the nature, scope, conditions, amount, maturity, and other terms of the particular indebtedness must be shown in each case.

Ordinarily an amount used to pay or retire an indebtedness, in whole or in part, at or prior to the maturity and in accordance with the terms thereof will be considered reasonable, and may be allowable as a credit for the year in which so used, if no adjustment is required by reason of an amount set aside in a prior year for payment or retirement of the same indebtedness.

All amounts *irrevocably* set aside for the payment or retirement of an indebtedness in accordance with and pursuant to the terms of the obligation, for example, the annual contribution *to trustees* required by the provisions of a mandatory sinking fund agreement, will be considered as complying with the statutory requirement of reasonableness. To be considered reasonable it is not necessary that the plan of retirement provide for a retroactive setting aside of amounts for years prior to that in which the plan is adopted. However, if a voluntary plan was adopted prior to 1938, no adjustment is allowable in respect of the amounts set aside in the years prior to 1938.

[SEC. 27. *Corporation dividends paid credit.*]

(b) *Basic surtax credit.*—As used in this title the term "basic surtax credit" means the sum of:

(1) The dividends paid during the taxable year, increased by the consent dividends credit provided in section 28, and reduced by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations;

(2) In the case of a taxable year beginning after December 31, 1938, the net operating loss credit provided in section 26 (c) (1);

(3) The bank affiliate credit provided in section 26 (d).

The aggregate of the amounts under paragraphs (2) and (3) shall not exceed the adjusted net income for the taxable year.

ART. 27 (b)-1. *Basic surtax credit.*—The amount constituting the basic surtax credit of a corporation for the taxable year consists of the sum of the following, less the amount allowable as a deduction under section 121 (relating to the deduction of dividends paid on certain preferred stock of certain corporations):

(1) The dividends paid during the taxable year (subject to the qualifications, limitations, and exceptions provided in sections 27 (d) to 27 (i), both inclusive) plus the consent dividends credit provided by section 28, less the credit for interest on certain obligations of the United States and its instrumentalities, provided by section 26 (a); and

(2) The smaller of the following:

(*a*) The sum of the net operating loss credit for the preceding taxable year provided in section 26 (c) (1) (if the current taxable year began after December 31, 1938) and the bank affiliate credit provided in section 26 (d).

(*b*) The adjusted net income for the taxable year.

ART. 27 (b)-2. *Dividends paid*—(*a*) *When dividends are considered paid.*—A dividend will be considered as paid when it is received by the shareholder. An allowance for dividends paid will not be permitted unless the shareholder receives the dividend during the taxable year for which the credit is claimed.

If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mails, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by the shareholder within the taxable year, a presumption arises that the dividend was paid to the shareholder in such year.

The payment of a dividend during the taxable year to the authorized agent of the shareholder will be deemed payment of the dividend to the shareholder during such year.

If a corporation, instead of paying the dividend directly to the shareholder, credits the account of the shareholder on the books of the corporation with the amount of the dividend, the allowance for a dividend paid will not be permitted unless it be shown to the satisfaction of the Commissioner that such crediting constituted payment of the dividend to the shareholder within the taxable year.

An allowance will not be permitted for the amount of a dividend credited during the taxable year upon an obligation of the shareholder to the corporation unless it is shown to the satisfaction of the Commissioner that such crediting constituted payment of the dividend to the shareholder within the taxable year.

In the case of a stock dividend, if the shares (other than fractional shares payable to bearer) constituting the dividend are not entered or registered on the books of the corporation in the name of the shareholder (or his nominee or transferee) within the taxable year, the dividend will not be deemed to have been paid in such year. Delivery of a certificate, or certificates, for such new shares, within the taxable year, constitutes prima facie evidence of the payment of the dividend.

If the dividend is payable in obligations of the corporation, they should be entered or registered in the taxable year on the books of the corporation, in the name of the shareholder (or his nominee or transferee), and, in the case of obligations payable to bearer, should be received in the taxable year by the shareholder (or his nominee or transferee), to constitute payment of the dividend within the taxable year.

In the case of a dividend from which the tax has been deducted and withheld as required by section 143 or 144, the dividend is considered as paid when such deducting and withholding occur.

(*b*) *Methods of accounting.*—The determination of whether a dividend has been paid to the shareholder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books or upon the method of accounting upon the basis of which the net income of the corporation is computed. See section 43.

(*c*) *Records.*—Every corporation claiming an allowance for dividends paid shall keep such permanent records as are necessary (1) to establish that the dividends with respect to which such allowance is claimed were actually paid during the taxable year and (2) to supply the information required to be filed with the income tax return of the corporation. Such corporation shall file with its return (*a*) a copy of the dividend resolution; and (*b*) a concise statement of the pertinent facts relating to the payment of the dividend, clearly specifying (1) the medium of payment and (2), if not paid in money, the fair market value and adjusted basis (or face value, if paid in its own obligations) on the date of distribution of the property distributed, and the manner in which such fair market value and adjusted basis were determined. Canceled dividend checks and receipts obtained from shareholders acknowledging payment of dividends paid otherwise than by check need not be filed with the return but shall be kept by the corporation as a part of its records.

[SEC. 27. *Corporation dividends paid credit.*]

(c) *Dividend carry-over.*—There shall be computed with respect to each taxable year of a corporation a dividend carry-over to such year from the two preceding taxable years, which shall consist of the sum of—

(1) The amount of the basic surtax credit for the second preceding taxable year, reduced by the adjusted net income for such year, and further reduced by the amount, if any, by which the adjusted net income for the first preceding taxable year exceeds the sum of—

(A) The basic surtax credit for such year; and

(B) The excess, if any, of the basic surtax credit for the third preceding taxable year (if not beginning before January 1, 1936) over the adjusted net income for such year; and

(2) The amount, if any, by which the basic surtax credit for the first preceding taxable year exceeds the adjusted net income for such year.

In the case of a preceding taxable year, referred to in this subsection, which begins in 1936 or 1937, the adjusted net income shall be the adjusted net income as defined in section 14 of the Revenue Act of 1936, and the basic surtax credit shall be only the dividends paid credit computed under the Revenue Act of 1936 without the benefit of the dividend carry-over provided in section 27 (b) of such Act.

ART. 27 (c)-1. *Dividend carry-over.*—The dividend carry-over to a given taxable year is computed as follows:

(*a*) If the basic surtax credit for the preceding taxable year exactly equals the adjusted net income for such year, the dividend carry-over is the amount of the excess of the basic surtax credit for the second preceding taxable year over the adjusted net income for such year.

(*b*) If the basic surtax credit for the preceding taxable year exceeds the adjusted net income for such year, the dividend carry-over is the amount of such excess plus the excess of the basic surtax credit for the second preceding taxable year over the adjusted net income for such year.

(*c*) If the basic surtax credit for the preceding taxable year is less than the adjusted net income for such year, the dividend carry-over is the amount by which the basic surtax credit for the second preceding taxable year exceeds the adjusted net income for such year reduced by the excess of the adjusted net income for the first preceding taxable year over the sum of the basic surtax credit for such year and the excess of the basic surtax credit for the third preceding taxable year (if beginning after December 31, 1935) over the adjusted net income for such year.

In computing the dividend carry-over the adjusted net income for a preceding taxable year which begins in 1936 or 1937 shall be the adjusted net income as defined in section 14 (a) (1) of the Revenue Act of 1936 and the basic surtax credit for such preceding taxable year shall be only the dividends paid credit computed under section 27 of the Revenue Act of 1936 without the benefit of the dividend carry-over provided in section 27 (b) of such Act.

Every corporation claiming a dividend carry-over for any taxable year shall file with its return for such year a concise statement setting forth the amount of the dividend carry-over claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the dividend carry-over claimed.

The computation of the dividend carry-over may be illustrated by the following examples:

Example (1): The X Corporation, which makes its income tax returns on the calendar year basis, has an adjusted net income of $150,000 and a dividends paid credit (computed without regard to any dividend carry-over) of $225,000 for 1937. For 1938 its adjusted net income is $200,000 and its basic surtax credit is $350,000, and for 1939 its adjusted net income and its basic surtax credit are each $175,000. Its dividend carry-over to 1940 is $150,000, computed as follows:

(1) Basic surtax credit for 1938	$350,000
(2) Less adjusted net income for 1938	200,000
(3) Dividend carry-over to 1940 ((1) minus (2))	150,000

Since the basic surtax credit for 1939 exactly equals the adjusted net income for that year, neither that year nor the year 1937 need be taken into account. The preceding taxable year (1939) is taken into account only if the basic surtax credit for such year exceeds the adjusted net income for such year or if the adjusted net income for such year exceeds the sum of the basic surtax credit for such year and the excess of the basic surtax credit (dividends paid credit if in 1936 or 1937) for the third preceding taxable year (1937), if beginning after December 31, 1935, over the adjusted net income for such year. The third preceding taxable year (1937) is taken into account only if it began after December 31, 1935, and if the adjusted net income for the first preceding taxable year (1939) exceeds the basic surtax credit for such year, in which case it operates to reduce the amount of such excess which must be deducted from the carry-over from the second preceding taxable year (1938).

Example (2): The Y Corporation, which makes its income tax returns on the calendar year basis, has an adjusted net income of $100,000 and a dividends paid credit (computed without regard to any dividend carry-over) of $150,000 for 1937. For 1938 its adjusted net income is $50,000 and its basic surtax credit is $75,000, and for 1939 its adjusted net income and basic surtax credit are $25,000 and $100,000, respectively. Its dividend carry-over to 1940 is $100,000, computed as follows:

Year 1938

(1) Basic surtax credit	$75,000	
(2) Less adjusted net income	50,000	
(3) Excess of basic surtax credit over adjusted net income		$25,000

Year 1939

(4) Basic surtax credit	$100,000	
(5) Less adjusted net income	25,000	
(6) Excess of basic surtax credit over adjusted net income		75,000
(7) Dividend carry-over to 1940 (sum of (3) and (6))		100,000

For reason why the year 1937 is not taken into account, see explanation at end of example (1).

Example (3): The Z Corporation, which makes its income tax returns on the calendar year basis, has an adjusted net income of $90,000, and a dividends paid credit (computed without regard to any dividend carry-over) of $150,000 for 1937. For 1938 its adjusted net income is $60,000 and its basic surtax credit is $160,000, and for 1939 its adjusted net income and basic surtax credit are $120,000 and $25,000, respectively. Its dividend carry-over to 1940 is $65,000, computed as follows:

Year 1938

(1) Basic surtax credit	$160,000			
(2) Less adjusted net income	60,000			
(3) Excess of basic surtax credit over adjusted net income				$100,000

Year 1939

(4) Adjusted net income			$120,000	
(5) Basic surtax credit		$25,000		

Year 1937

(6) Dividends paid credit	$150,000			
(7) Less adjusted net income	90,000			
(8) Excess of dividends paid credit over adjusted net income		$60,000		
Sum of (5) and (8)			$85,000	
(9) Excess of adjusted net income over sum of items (5) and (8)				$35,000
(10) Dividend carry-over to 1940 ((3) minus (9))				65,000

Example (4): If the facts in example (3) were the same except that the years involved were 1935, 1936, 1937, and 1938, instead of 1937, 1938, 1939, and 1940, respectively, the dividend carry-over to 1938 would be $5,000, computed as follows:

Year 1936

(1) Basic surtax credit (i. e., dividends paid credit)	$160,000	
(2) Less adjusted net income	60,000	
(3) Excess of basic surtax credit over adjusted net income		$100,000

Year 1937

(4) Adjusted net income	$120,000	
(5) Less basic surtax credit (i. e., dividends paid credit)	25,000	
(6) Excess of adjusted net income over basic surtax credit		95,000
(7) Dividend carry-over to 1938 ((3) minus (6))		5,000

The year 1935 cannot be taken into account because it began prior to January 1, 1936.

[SEC. 27. *Corporation dividends paid credit.*]

(*d*) *Dividends in kind.*—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the amount with respect thereto which shall be used in computing the basic surtax credit shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

ART. 27 (d)-1. *Dividends in kind.*—Section 27 (d) imposes limitations upon the extent to which dividends paid in assets (other than money) may be recognized for purposes of determining the amount of the allowance for dividends paid which may be included in the basic surtax credit. Irrespective of the form of the corporate resolution by which a dividend is declared, if the dividend is ultimately and actually paid by the corporation in any property other than money, constituting its corporate assets, the amount of the allowance for dividends paid to which the corporation is entitled with respect thereto cannot exceed the lesser of the two following amounts determined as of the time of payment:

(1) The adjusted basis of such property in the hands of the corporation as provided for in section 113; or

(2) The fair market value of such property.

As used in this article the term "property" includes shares of capital stock of the corporation making the dividend distribution if such shares of stock are held by it as an investment. Unless shown to the contrary, shares of capital stock once issued but thereafter acquired by the corporation in any manner whatsoever, but not retired, shall be deemed to be held by the corporation as an investment. The term "property" also includes obligations upon which the corporation making the distribution is liable as a guarantor, indorser, or surety.

The application of section 27 (d) may be illustrated by the following example:

Example: The S Corporation, in 1930, purchased stock of the Y Corporation for $100,000. In 1938 such stock had a fair market value of $70,000. During the period of its ownership of such stock, the S Corporation received distributions amounting to $5,000 out of earnings or profits of the Y Corporation accumulated before March 1, 1913. In 1938 the corporation used such stock for the payment of a dividend. The allowance for dividends paid for purposes of inclusion in the basic surtax credit for 1938 is $70,000, computed as follows:

Purchase price, or cost of stock	$100,000
Less tax-free distribution	5,000
Adjusted basis of stock in the hands of the corporation at the time of the dividend payment	95,000
Fair market value of stock at the time of the dividend payment	70,000
Allowance for dividends paid for purposes of inclusion in the basic surtax credit for 1938	70,000

Since the fair market value of the stock ($70,000) at the time of the dividend payment is less than the adjusted basis ($95,000) of the stock in the hands of the corporation at the time of the dividend payment, the lesser amount ($70,000) should be used as the allowance for dividends paid for purposes of computing the basic surtax credit for 1938 with respect to such stock.

[SEC. 27. *Corporation dividends paid credit.*]

(*e*) *Dividends in obligations of the corporation.*—If a dividend is paid in obligations of the corporation, the amount with respect thereto which shall be used in computing the basic surtax credit shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value of any such dividend paid in any taxable year of the corporation beginning after December 31, 1935, is lower than the face value, then when the obligation is redeemed by the corporation in a taxable year of the corporation beginning after December 31, 1937, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.

ART. 27 (e)-1. *Dividends in obligations of the corporation.*—Section 27 (e) is concerned solely with the amount of the allowance for dividends paid for purposes of inclusion in the basic surtax credit to the extent that dividends are paid by a corporation in its own obligations. If the corporation ultimately pays a dividend in its own obligations (regardless of the form of the corporate resolution by which the dividend is declared), the amount of the allowance for dividends paid to which it is entitled with respect thereto for the year in which such dividend is paid is limited to the lesser of the face value or fair market value of such obligations as of the date of payment. If in a taxable year of the corporation beginning after December 31, 1935, the allowance for dividends paid as of the date of payment is limited to the fair market value of the corporate obligations distributed and the corporation redeems such obligations in a taxable year beginning after December 31, 1937, the corporation becomes entitled to an additional allowance for dividends paid in computing the basic surtax credit for the taxable year in which it redeems such obligations, but only in the event that the amount at which such obligations are redeemed is higher than their fair market value at the time of the distribution. The amount of such additional allowance is the excess of the price at which such obligations are redeemed over their fair market value at the time of the distribution, subject to the restriction that such excess be diminished by any amounts which were allowable as deductions for amortized bond discount or bond issue commissions and expenses allocable to the obligations redeemed in computing the net income of the corporation for any taxable year. A corporation is entitled to such additional allowance regardless of the identity of the holders of the obligations at the time of their redemption.

The term "obligations" as used in this article means any legal liability on the part of the corporation (not including liability as a guarantor, indorser, or surety), regardless of when incurred, to pay a fixed or determinable sum of money, evidenced in writing executed by the corporation. The term "redeemed" as used in this article includes (1) repurchase in the open market for investment or sinking fund purposes, (2) retirement, or (3) cancellation of the obligations before, at, or after maturity.

The application of section 27 (e) may be illustrated by the following example:

Example: The X Corporation, which makes its income tax returns on the calendar year basis, declared a dividend of $85,000 in 1936, payable in that year in its 5 percent bonds at 85. Pursuant to such declaration, bonds having an aggregate face value of $100,000 were issued during 1936 in payment of the dividend. The fair market value of the bonds at the time of issuance was $75,000. The dividends paid credit for 1936 was the fair market value of the bonds at the time of the dividend payment ($75,000), since such fair market value was lower than the face value ($100,000) of the obligations.

The bonds were redeemed in 1938. The corporation prior to the redemption of the bonds at face value deducted in its returns over the life of the bonds the $15,000 bond discount resulting from the payment in 1936 of the $85,000 dividend in bonds having a face value of $100,000. The allowance for dividends paid for purposes of computing the basic surtax credit with respect to the bond redemption for the taxable year 1938, in which the redemption of the bonds occurs, is $10,000, computed as follows:

Redemption price of bonds	$100,000
Less fair market value of bonds when dividend was paid in 1936	75,000
Difference	25,000
Less bond discount allowed as a deduction in computing net income	15,000
Amount treated as dividend paid in 1938	10,000

[SEC. 27. *Corporation dividend paid credit.*]

(*f*) *Taxable stock dividends.*—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the amount with respect thereto which shall be used in computing the basic surtax credit shall be the fair market value of the stock or the stock right at the time of the payment.

ART. 27 (f)-1. *Taxable stock dividends.*—The allowance for dividends paid provided by section 27 (b) (1) is limited by section 27 (f), in the case of distributions in stock dividends or stock rights, to distributions which are taxable dividends in the hands of shareholders under section 115 (f). Such allowance, however, is limited in amount to the fair market value of such stock or stock rights at the time of the payment of the dividend. As to a distribution by a corporation of its own capital stock held as an investment, see article 27 (d)-1.

[SEC. 27. *Corporation dividends paid credit.*]

(*g*) *Distribution in liquidation.*—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the basic surtax credit under this section, be treated as a taxable dividend paid.

ART. 27 (g)-1. *Dividends paid credit for distributions in liquidation*—(*a*) *Distributions which diminish earnings or profits.*—To the general rule that an allowance for dividends paid is permitted only with respect to taxable dividends paid, section 27 (g) makes one exception, namely, for that part of an amount distributed in liquidation which, under the Act, constitutes a distribution of, and is properly chargeable to, earnings or profits accumulated after February 28, 1913. Thus, a distribution either in complete or partial liquidation of a corporation is treated by the Act as one constituting in part a distribution of, and being properly chargeable to, earnings or profits, if—

(1) Under the provisions of section 115 (c), the amounts distributed in liquidation are treated as received in payment in exchange for the stock; and

(2) Under the provisions of section 112, the gain or loss, if any, from such exchange is recognized or the gain is taxed as provided in section 112 (b) (7).

In such a case, an allowance for dividends paid may be included in the basic surtax credit for the amount actually involved in such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, even though the method of taxation of the distribution is that ordinarily employed with respect to the gain or loss realized and recognized upon an exchange, rather than that employed with respect to a taxable dividend.

On the other hand, certain transactions described in sections 112 and 115 are treated, for the purposes of the Act, not as distributions to the shareholders of earnings or profits, but as transfers of such earnings or profits intact to another corporation in whose hands such earnings or profits, being available for distribution by it as dividends to its shareholders, have essentially the same status for the purposes of the Act as earnings or profits derived from its own operations. Characteristic of these transactions is the circumstance that the gain or loss realized from the receipt by the shareholders of property is not recognized by the Act. No allowance for dividends paid is permissible with respect to such transactions.

(*b*) *Amount properly chargeable to earnings or profits.*—In the case of a distribution in liquidation with respect to which an allowance for dividends paid is permissible (see paragraph (*a*) of this article) the amount of the allowance is equal to the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings or profits accumulated since February 28, 1913, there must be deducted from the amount of the distribution that part allocable to capital account. The capital account, for purposes of these regulations, includes not only amounts representing the par or stated value of the stock with respect to which the liquidating distribution is being made but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which, for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings or profits accumulated since February 28, 1913. The application of this paragraph may be illustrated by the following example:

Example: The Y Corporation, which makes its income tax returns on the calendar year basis, was organized on January 1, 1910, with an authorized and outstanding capital stock of 2,000 shares of common stock of a par value of $100 each and 1,000 shares of participating preferred stock of a par value of $100 each. The preferred stock was to receive annual dividends of $7 per share and $100 per share on complete liquidation of the corporation in priority to any payments on common stock, and was to participate equally with the common stock in either instance after the common stock had received a similar amount. However, the preferred stock was redeemable in whole or in part at the option of the board of directors at any time at $106 per share plus its proportion of the earnings of the company at the time of such redemption. In 1910 the preferred stock was issued at $106 per share, for a total of $106,000, and the common stock was issued, at $100 per share, for a total of $200,000. On July 15, 1938, the company had a paid-in surplus of $6,000, consisting of the premium received on the preferred stock, earnings or profits of $30,000 accumulated prior to March 1, 1913, and earnings or profits accumulated since February 28, 1913, of $75,000. On July 15, 1938, the option with respect to the preferred stock was exercised and the entire amount of such stock was redeemed at $141 per share or a total of $141,000 in a transaction upon which gain or loss to the distributees resulting from the exchange was determined and recognized under the Act, such transaction being only a partial liquidation under section 115 (c). The amount of the distribution allocable to capital account was $116,000 ($100,000 attributable to par value, $6,000 attributable to paid-in surplus, and $10,000 attributable to earnings or profits accumulated prior to March 1, 1913). The remainder, $25,000 ($141,000, the amount of the distribution, less $116,000, the amount allocable to capital account) is properly chargeable to the earnings or profits accumulated since February 28, 1913, and is allowable as dividends paid.

(*c*) *Credit in respect of earnings or profits transferred under certain tax-free transactions.*—If, as a result of one or more transactions described in section 112, a corporation's earnings or profits accumulated after February 28, 1913, and its undistributed earnings or profits of the taxable year, shall have become the earnings or profits of another corporation subject to distribution as dividends by such other corporation, any dividend paid by the transferee corporation during that portion of the transferor's taxable year subsequent to the consummation of such tax-free transaction may, subject to the provisions of section 115, be apportioned and allocated to the transferor as a distribution out of such earnings or profits of the transferor. The resolution of the board of directors of the transferee shall specifically designate the distribution, or part thereof, so apportioned and allocated. For the purposes of the allowance for dividends paid, any such distribution so allocated shall be treated as a dividend paid only in the computation of the basic surtax credit allowable to the transferor, and must be consistently so treated by both corporations for the current and succeeding taxable years. Each corporation shall file as a part of its return for the taxable year involved, (1) a statement setting forth concisely all of the material facts, including the date and the character of the transaction under section 112, the status at that time of the earnings or profits of both corporations, the date and amount of all dividend distributions subsequently made, and the particular distribution or portion thereof designated as effecting a distribution of the earnings or profits of the transferor corporation; and (2) a certified copy of the resolution of the board of directors of the transferee corporation with respect to the distribution. No allowance for dividends paid based upon such apportionment and allocation will be permitted unless the Commissioner is satisfied that the transferor corporation is entitled thereto pursuant to the provisions of this paragraph and that there has been a full compliance with the requirements of this paragraph. The provisions of this paragraph may be illustrated by the following example:

Example: The P Corporation, which makes its income tax returns on the basis of a fiscal year ending March 31, owned all of the capital stock of the S Corporation. The S Corporation, which makes its returns on the calendar year basis, was completely liquidated on December 1, 1938. At that time, the S Corporation had earnings or profits accumulated subsequent to February 28, 1913, in the amount of $50,000, in addition to earnings or profits for 1938 of $20,000, and an adjusted net income of $45,000. It had paid no dividends prior to its liquidation. The P Corporation had earnings or profits accumulated subsequent to February 28, 1913, in the amount of $60,000 in addition to earnings or profits of the taxable year computed as of the end of the year in the amount of $80,000, and an adjusted net income in the amount of $60,000. The P Corporation pays dividends as follows: June 15, 1938, $25,000; September 15, 1938, $25,000; December 15, 1938, $25,000; and March 15, 1939, $25,000. No portion of the dividends paid on June 15 and September 15 prior to the liquidation and no portion of the dividend paid on March 15, 1939, after the close of the taxable year of the S Corporation may be allocated to the S Corporation. The dividend paid on December 15 may, by appropriate corporate action, be made as one effecting a distribution out of the current earnings or profits of the S Corporation to the extent of $20,000. No part of that distribution may be allocated to the S Corporation's accumulated earnings or profits since, under section 115 (b), the earnings or profits of the P Corporation and the S Corporation for the taxable year ($100,000) are sufficient in amount to cover all the distributions made during that year ($100,000).

[SEC. 27. *Corporation dividends paid credit.*]

(*h*) *Preferential dividends.*—The amount of any distribution (although each portion thereof is received by a shareholder as a taxable dividend), not made in connection with a consent distribution (as defined in section 28 (a) (4)), shall not be considered as dividends paid for the purpose of computing the basic surtax credit, unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference. For a distribution made in connection with a consent distribution, see section 28.

ART. 27 (h)-1. *Preferential distributions.*—Section 27 (h) imposes a limitation upon the general rule that a corporation is entitled to an allowance for dividends paid with respect to all dividends which it actually pays during the taxable year. Before a corporation may be entitled to any such allowance with respect to a distribution, regardless of the medium in which the distribution is made, every shareholder of the class of stock with respect to which the distribution is made must be treated the same as every other shareholder of that class, and no class of stock may be treated otherwise than in accordance with its dividend rights as a class. The limitation imposed by the Act is unqualified, except in the case of a partial distribution (see section 28 (a) (5)) made in connection with a consent distribution as defined in section 28 (a) (4), if the entire distribution composed of such partial distribution and consent distribution (see section 28 (e)) is not preferential. The existence of a preference is sufficient to prohibit allowance regardless of the fact (1) that such preference is authorized by all the shareholders of the corporation, or (2) that the part of the distribution received by the shareholder benefited by the preference is taxable to him as a dividend. A corporation will not be entitled to an allowance for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. Nor will a corporation be entitled to an allowance for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock. A preference exists if any rights to preference inherent in any class of stock are violated. The disallowance, where any preference in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution. The term "distribution," as used in this article, includes a dividend as defined in section 115, and a distribution in liquidation referred to in section 27 (g).

The application of the provisions of section 27 (h), relating to distributions which are preferential, may be illustrated by the following examples:

Example (1): A, B, C, and D are the owners of all the shares of class A common stock in the M Corporation, which makes its income tax returns on a calendar year basis. With the consent of all the shareholders, the M Corporation, on July 15, 1938, declared a dividend of $5 a share payable in cash on August 1, 1938, to A. On September 15, 1938, it declared a dividend of $5 a share payable in cash on October 1, 1938, to B, C, and D. No allowance for dividends paid for the taxable year 1938 is permitted to the M Corporation with respect to any part of the dividends paid on August 1, 1938, and October 1, 1938.

Example (2): The N Corporation, which makes its income tax returns on the calendar year basis, has a capital of $100,000 (consisting of 1,000 shares of common stock of a par value of $100) and earnings or profits accumulated after February 28, 1913, in the amount of $50,000. In the year 1938, the N Corporation distributes $7,500 in cancellation of 50 shares of the stock owned by three of the four shareholders of the corporation. No dividends paid credit is allowable under section 27 (h) with respect to such distribution.

Example (3): The P Corporation has two classes of stock outstanding, 10 shares of cumulative preferred, owned by E, entitled to $5 per share and on which no dividends have been paid for two years, and 10 shares of common, owned by F. On December 31, 1938, the corporation distributes a dividend of $125, $50 to E and $75 to F. The corporation is entitled to no allowance for any part of such dividend paid, since there has been a preference to F. If, however, the corporation had distributed $100 to E and $25 to F, it would have been entitled to include $125 in its basic surtax credit as a dividend paid.

[SEC. 27. *Corporation dividends paid credit.*]

(*i*) *Nontaxable distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, such part shall not be included in computing the basic surtax credit.

ART. 27 (i)-1. *Nontaxable distributions.*—No allowance for dividends paid is permitted with respect to any part of the distribution by a corporation to its shareholders which is—

(*a*) not out of earnings or profits of the taxable year or out of earnings or profits of the corporation accumulated subsequent to February 28, 1913 (see section 115), or, in the case of distributions in liquidation, not properly chargeable to earnings or profits of the corporation accumulated after February 28, 1913, under article 27 (g)-1;

(*b*) in the case of a corporation which was classified as a personal service corporation under the Revenue Act of 1918 or the Revenue Act of 1921, out of earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or section 218 of the Revenue Act of 1921 (see section 115 (e)); or

(c) a distribution in stock of the corporation or rights to acquire its stock which does not constitute income to its shareholders within the meaning of the sixteenth amendment to the Constitution (see section 115 (f) and articles 115-3 and 115-4).

The effect of subsections (h) and (i) of section 27 is that no allowance for dividends paid may be included in the basic surtax credit with respect to any distribution unless each of the shareholders of that class, who are subject to taxation under Title I for the period in which the distribution is made, receives a taxable dividend as a result of the distribution. (See also section 27 (g).)

The application of section 27 (i) may be illustrated by the following examples:

Example (1): A, B, C, and D are the shareholders of the Y Corporation, which makes its income tax returns on the calendar year basis, D being an educational corporation exempt from income tax under section 101. On July 15, 1938, the Y Corporation paid a dividend within the meaning of section 115) in cash of $1,000. A and B make their returns on the calendar year basis, but C makes his return on the basis of the fiscal year ending July 31. The Y Corporation is entitled to an allowance for dividends paid in the amount of $1,000 with respect to the dividends paid on July 15.

Example (2): If the facts in the preceding example are the same, except that A and B make their returns on the basis of the fiscal year ending July 31, the Y Corporation is entitled to an allowance for dividends paid in the amount of $1,000 with respect to the dividends paid on July 15.

SEC. 28. *Consent dividends credit.*

(a) *Definitions.*—As used in this section—

(1) *Consent stock.*—The term "consent stock" means the class or classes of stock entitled, after the payment of preferred dividends (as defined in paragraph (2)), to a share in the distribution (other than in complete or partial liquidation) within the taxable year of all the remaining earnings or profits, which share constitutes the same proportion of such distribution regardless of the amount of such distribution.

ART. 28 (a) (1)-1. *Consent stock.*—The term "consent stock," as defined in section 28 (a) (1), includes what is generally known as common stock. It also includes participating preferred stock, the participation rights of which are unlimited. The application of section 28 (a) (1) may be illustrated as follows:

If in the case of X Corporation there is only one class of stock outstanding, it would all be consent stock. If, on the other hand, there were two classes of stock, class A and class B, and class A was entitled to 6 percent before any distribution could be made on class B, but class B was entitled to everything distributed after class A had received its 6 percent, only class B stock would be consent stock. Similarly, if class A, after receiving its 6 percent, was to participate equally or in some fixed proportion with class B until it had received a second 6 percent, after which class B alone was entitled to any further distributions, only class B stock would be consent stock. The same result would follow if the order of preferences were class A 6 percent, then class B 6 percent, then class A a second 6 percent, either alone or in conjunction with class B, then class B the remainder. If, however, class A stock is entitled to ultimate participation without limit as to amount, then it, too, may be consent stock. For example, if class A is to receive 3 percent and then share equally or in some fixed proportion with class B in the remainder of the earnings or profits distributed, both class A stock and class B stock are consent stock.

[SEC. 28. *Consent dividends credit.*]

[(a) *Definitions.*—As used in this section—]

(2) *Preferred dividends.*—The term "preferred dividends" means a distribution (other than in complete or partial liquidation), limited in amount, which must be made on any class of stock before a further distribution (other than in complete or partial liquidation) of earnings or profits may be made within the taxable year.

ART. 28 (a) (2)-1. *Preferred dividends.*—The term "preferred dividends," as defined in section 28 (a) (2), includes all fixed amounts (whether determined by percentage of par value, a stated return expressed in a certain number of dollars per share, or otherwise) the distribution (other than in liquidation) of which on any class of stock is a condition precedent to a further distribution (other than in liquidation) of earnings or profits. A distribution, though expressed in terms of a fixed amount, is not a preferred dividend, however, unless it is preferred over a subsequent distribution within the taxable year upon some other class or classes of stock than the one on which it is payable. The application of section 28 (a) (2) may be illustrated as follows:

If, in the case of the X Corporation, there are only two classes of stock outstanding, class A and class B, and class A is entitled to a distribution of 6 percent of par, after which the balance of the earnings and profits are distributable on class B exclusively, class A's 6 percent is a preferred dividend. If the order of preferences is class A $6 per share, class B $6 per share, then class A and class B in fixed proportions until class A receives $3 more per share, then class B the remainder, all of class A's $9 per share and $6 per share of the amount distributable on class B are preferred dividends. The amount which class B is entitled to receive in conjunction with the payment to class A of its last $3 per share is not a preferred dividend, because the payment of such amount is preferred over no subsequent distribution except one made on class B itself. Finally, if a distribution must be $6 on class A, $6 on class B, then on class A and class B share and share alike, the distribution on class A of $6 and the distribution on class B of $6 are both preferred dividends.

[SEC. 28. *Consent dividends credit.*]

[(a) *Definitions.*—As used in this section—]

(3) *Consent dividends day.*—The term "consent dividends day" means the last day of the taxable year of the corporation, unless during the last month of such year there have occurred one or more days on which was payable a partial distribution (as defined in paragraph (5)), in which case it means the last of such days.

ART. 28 (a) (3)-1. *Consent dividends day.*—The term "consent dividends day" is defined in section 28 (a) (3). If there was no partial distribution (as defined in section 28 (a) (5)) payable during the last month of the corporation's taxable year, the consent dividends day is the last day of such taxable year. If there were one or more days during such last month on which was payable a partial distribution, the consent dividends day is the last of such days. The day upon which shareholders, under the terms of the resolution of the board of directors directing the distribution, are entitled to receive the distribution is the day it is payable.

[SEC. 28. *Consent dividends credit.*]

[(a) *Definitions.*—As used in this section—]

(4) *Consent distribution.*—The term "consent distribution" means the distribution which would have been made if on the consent dividends day (as defined in paragraph (3)) there had actually been distributed in cash and received by each shareholder making a consent filed by the corporation under subsection (d), the specific amount stated in such consent.

ART. 28 (a) (4)-1. *Consent distribution.*—The term "consent distribution," as defined in section 28 (a) (4), does not include any actual distributions but is limited to the hypothetical distribution evidenced by shareholders' consents. The consent distribution equals the aggregate of all the amounts specified in the several consents, whether or not, if actually distributed, such amounts would have constituted in whole or in part a return of capital. Section 28 (a) (4) may be illustrated by the following example:

Example: The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, consisting of 500 shares, 200 of which are owned by A, and 300 by B. On December 15, 1938, the corporation distributes to A $5 per share, or $1,000. On December 31, 1938, B executes a consent to include $1,500 in his gross income as a taxable dividend. At the beginning of 1938 the corporation had no accumulated earnings or profits. For the taxable year 1938 the earnings or profits are $2,000. Nevertheless the corporation will be deemed to have made a consent distribution of $1,500 on December 15.

[SEC. 28. *Consent dividends credit.*]
[(*a*) *Definitions.*—As used in this section—]

(5) *Partial distribution.*—The term "partial distribution" means such part of an actual distribution, payable during the last month of the taxable year of the corporation, as constitutes a distribution on the whole or any part of the consent stock (as defined in paragraph (1)), which part of the distribution, if considered by itself and not in connection with a consent distribution (as defined in paragraph (4)), would be a preferential distribution, as defined in paragraph (6).

ART. 28 (a) (5)-1. *Partial distribution.*—The term "partial distribution," as defined in section 28 (a) (5), does not include preferred dividends even though payable on consent stock. The application of section 28 (a) (5) may be illustrated by the following example:

Example: The X Corporation, which makes its income tax returns on the calendar year basis, has only two classes of stock outstanding, class A and class B, each of which is consent stock. Class A, consisting of 500 shares, is entitled to a preference of $3 per share, after which class B, consisting of 500 shares, is to receive $3 per share, whereupon class A and class B are entitled to share equally in any further distributions of earnings or profits. On December 15, 1938, the X Corporation distributes $6 per share or $3,000 on class A stock, and $3 per share or $1,500 on class B stock. Such distribution, to the extent of $1,500 paid on class A stock, is a partial distribution.

[SEC. 28. *Consent dividends credit.*]
[(*a*) *Definitions.*—As used in this section—]

(6) *Preferential distribution.*—The term "preferential distribution" means a distribution which is not pro rata, or which is with preference to any share of stock as compared with other shares of the same class, or to any class of consent stock as compared with any other class of consent stock.

ART. 28 (a) (6)-1. *Preferential distribution.*—A preferential distribution is an actual distribution (other than the distribution of a preferred dividend as defined in section 28 (a) (2)), or a consent distribution, or a combination of the two, upon consent stock, which involves a preference to one or more shares of stock as compared with other shares of the same class or to one class of consent stock as compared with any other class of consent stock. Such a preference exists if there is distributed to any shareholder (in proportion to the number of shares held by him) more or less than his pro rata part of a distribution as compared with the distribution made to any other shareholder of the same class, or if there is distributed to all the shareholders of one class of consent stock in the aggregate more or less than their pro rata part of a distribution as compared with the distribution made to all the shareholders of any other class of consent stock. If such preference exists, the entire distribution is preferential.

Section 28 (a) (6) may be illustrated by the following examples:

Example (1): The X Corporation, which makes its income tax returns on the calendar year basis, has one class of consent stock outstanding, owned in equal amounts by A, B, and C. On December 15, 1938, the corporation makes a distribution in cash of $5,000 each to A and B, and $3,000 to C. The distribution is preferential. If A and B each receives a distribution in cash of $5,000 and C consents to include $3,000 in gross income as a taxable dividend, the combined actual and consent distribution is preferential. Similarly, if no one receives a distribution in cash, but A and B each consents to include $5,000 as a taxable dividend in gross income but C agrees to include only $3,000, the consent distribution is preferential.

Example (2): The Y Corporation, which makes its income tax returns on the calendar year basis, has only two classes of stock outstanding, each class being consent stock and consisting of 500 shares. Class A, with a par value of $40 per share, is entitled to two-thirds of any distribution of earnings and profits. Class B, with a par value of $20 per share, is entitled to one-third of any distribution of earnings and profits. On December 15, 1938, there is distributed on the class A stock $2 per share, or $1,000, and on the class B stock $2 per share, or $1,000. The distribution is preferential, inasmuch as the class B stock has received more than its pro rata share of the distribution:

[SEC. 28. *Consent dividends credit.*]
(*b*) *Corporations not entitled to credit.*—A corporation shall not to[1] be entitled to a consent dividends credit with respect to any taxable year—

(1) Unless, at the close of such year, all preferred dividends (for the taxable year and, if cumulative, for prior taxable years) have been paid; or

(2) If, at any time during such year, the corporation has taken any steps in, or in pursuance of a plan of, complete or partial liquidation of all or any part of the consent stock.

ART. 28 (b)-1. *Payment of preferred dividends.*—Section 28 (b) (1) provides that a corporation shall not be entitled to a consent dividends credit for any taxable year, regardless of compliance with other requirements of section 28, unless at the close of such year all preferred dividends (for the taxable year and, if cumulative, for prior taxable years) have been paid. Whatever form such payment takes, it must result in the complete discharge of the obligation of the corporation to pay such dividends. For what constitutes payment of a dividend before the close of the taxable year, see article 27 (b)-2. For what constitutes a preferred dividend see section 28 (a) (2). A preferred dividend will be considered paid for the purposes of this requirement, even though it is paid as part of a preferential dividend as defined in section 27 (h), and the corporation receives no credit for dividends paid in consequence thereof.

[1] So in original.

ART. 28 (b)-2. *Liquidation of consent stock.*—A corporation is not entitled to a consent dividends credit for any taxable year in which it has taken any steps in, or in pursuance of a plan of, complete or partial liquidation of all or any part of the consent stock.

Example: The X Corporation, which makes its income tax returns on the calendar year basis, has outstanding on January 1, 1938, 1,000 shares of class A stock, the dividend rights of which are limited to an annual return of $6 per share. It also has outstanding on that date 1,000 shares of class B stock, which is entitled to receive the entire amount of any distribution made of earnings or profits within the taxable year after the payment on class A of $6 per share. On April 1, 1938, the corporation makes a distribution in partial liquidation, whereby five shares of class B stock (consent stock) are canceled or redeemed. The corporation is barred from obtaining a consent dividends credit for the taxable year, regardless of compliance with other requirements of section 28. If, however, class A stock (not consent stock), instead of class B stock, had been canceled or redeemed in the liquidation, the corporation would not be barred, because of such liquidation, from obtaining a consent dividends credit.

The mere purchase by a corporation of its own stock for investment is not, within the meaning of section 28 (b) (2), the taking of any step in, or in pursuance of a plan of, complete or partial liquidation and will not prevent a corporation from obtaining a consent dividends credit for the taxable year.

[SEC. 28. *Consent dividends credit.*]
(*c*) *Allowance of credit.*—There shall be allowed to the corporation, as a part of its basic surtax credit for the taxable year, a consent dividends credit equal to such portion of the total sum agreed to be included in the gross income of shareholders by their consents filed under subsection (d) as it would have been entitled to include in computing its basic surtax credit if actual distribution of an amount equal to such total sum had been made in cash and each shareholder making such a consent had received, on the consent dividends day, the amount specified in the consent.

ART. 28 (c)-1. *Amount of consent dividends credit.*—The consent dividends credit forms part of the basic surtax credit (see section 27 (b) (1)). It consists of the amount which the corporation would be permitted to include in its basic surtax credit as a dividend paid if it had distributed to each shareholder whose consent has been filed pursuant to section 28 (d), and each such shareholder had received, on the consent dividends day (see section 28 (a) (3)), an amount equal to the amount specified in such consent. The amount of the consent dividends credit, therefore, cannot exceed the sum of the amounts specified in the several consents. It may, however, regardless of the fact that such amounts are treated and taxed in their entirety to the consenting shareholders as a dividend (see section 28 (f)), be smaller than the sum of the specified amounts, because it is limited to the amount which would have been allowed as dividends paid if an actual distribution had been made.

The provisions of section 28 (c) may be illustrated by the following example:

Example: The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year. Its earnings and profits for the calendar year 1938 amount to $8,000, there being at the beginning of the year 1938 no accumulated earnings or profits. A and B execute proper consents to include $5,000 each in their gross income as a dividend received by them on December 31, 1938. The sum of the amount specified in the consents executed by A and B is $10,000, but if $10,000 had actually been distributed by the X Corporation on December 31, 1938, only $8,000 would have constituted a dividend. The allowance for dividends paid, includible in the computation of the basic surtax credit, would have amounted to only $8,000. The consent dividends credit of the corporation, therefore, is limited to $8,000.

[SEC. 28. *Consent dividends credit.*]

(d) *Shareholders' consents.*—The corporation shall not be entitled to a consent dividends credit with respect to any taxable year—

(1) Unless it files with its return for such year (in accordance with regulations prescribed by the Commissioner with the approval of the Secretary) signed consents made under oath by persons who were shareholders, on the last day of the taxable year of the corporation, of any class of consent stock; and

(2) Unless in each such consent the shareholder agrees that he will include as a taxable dividend, in his return for the taxable year in which or with which the taxable year of the corporation ends, a specific amount; and

(3) Unless the consents filed are made by such of the shareholders and the amount specified in each consent is such, that the consent distribution would not have been a preferential distribution—

(A) If there was no partial distribution during the last month of the taxable year of the corporation, or

(B) If there was such a partial distribution, then when considered in connection with such partial distribution; and

(4) Unless in each consent made by a shareholder who is taxable with respect to a dividend only if received from sources within the United States, such shareholder agrees that the specific amount stated in the consent shall be considered as a dividend received by him from sources within the United States; and

(5) Unless each consent filed is accompanied by cash, or such other medium of payment as the Commissioner may by regulations authorize, in an amount equal to the amount that would be required by section 143 (b) or 144 to be deducted and withheld by the corporation if the amount specified in the consent had been, on the last day of the taxable year of the corporation, paid to the shareholder in cash as a dividend. The amount accompanying the consent shall be credited against the tax imposed by section 211 (a) or 231 (a) upon the shareholder.

ART. 28 (d)–1. *Making and filing of consents.*—A consent shall be made in duplicate on oath or affirmation on Form 972 in accordance with these regulations and the instructions on the form or issued therewith and may be made only by or on behalf of a person who was the actual owner on the last day of the corporation's taxable year of any class of consent stock, i. e., the person who would have been required to include in gross income any dividends on such stock actually distributed on the last day of such year. In the consent such person must agree:

(1) to include in his gross income for his taxable year in which or with which the taxable year of the corporation ends a specific amount as a taxable dividend: and

(2) if he is a shareholder who is taxable with respect to a dividend only if received from sources within the United States, that the specific amount stated in his consent shall be considered as a dividend received by him from sources within the United States.

A consent may be made at any time not later than the due date of the corporation's income tax return for the taxable year for which the credit is claimed. (See article 53–4.) With such return, and not later than the due date thereof, the corporation must file two duly executed duplicate originals of each consenting shareholder's consent, and a return on oath or affirmation on Form 973, showing by classes the stock outstanding on the first and last days of the taxable year, the dividend rights of such stock, distribution made during the taxable year to shareholders, and giving all the other information required by the form.

In the event that any consent filed by the corporation is made by a shareholder in the payment to whom of a dividend in cash, on the last day of the taxable year of the corporation, the corporation would have been required to deduct and withhold any amount as a tax under section 143 (b) or 144, such consent, when filed by the corporation, must be accompanied by payment of the amount which would have been required to be deducted and withheld if the amount specified in such consent had, on the last day of the corporation's taxable year, been paid to the shareholder in cash as a dividend. Such payment must be in one of the following forms:

(*a*) cash;

(*b*) United States postal money order;

(*c*) certified check drawn on a domestic bank, provided that the law of the place where the bank is located does not permit the certification to be rescinded prior to presentation;

(*d*) a cashier's check of a domestic bank; or

(*e*) a draft on a domestic bank or a foreign bank maintaining a United States agency or branch and payable in United States funds.

The amount of such payment shall be credited against the tax imposed by section 211 (a) or 231 (a) upon the shareholder.

ART. 28 (d)–2. *Consent distribution must be nonpreferential.*—The application of section 28 (d) (3) may be illustrated as follows:

Example: The X Corporation, which makes its income tax returns on the calendar year basis, has 200 shares of stock outstanding, owned by A and B in equal amounts. On December 15, 1938, the corporation distributes $600 to B and $100 to A. On December 31, 1938, A executes a consent to include $500 in his gross income as a taxable dividend, though such amount is not distributed to him. The X Corporation, assuming the other requirements of section 28 have been complied with, is entitled to a consent dividends credit of $500. Though considered by themselves, both the partial distribution of $700 and the consent distribution of $500 are preferential, when considered together they constitute a single nonpreferential distribution of $1,200.

[SEC. 28. *Consent dividends credit.*]

(c) *Consent distribution as part of entire distribution.*—If during the last month of the taxable year with respect to which shareholders' consents are filed by the corporation under subsection (d) there is made a partial distribution, then, for the purposes of this title, such partial distribution and the consent distribution shall be considered as having been made in connection with each other and each shall be considered together with the other as one entire distribution.

ART. 28 (e)–1. *Consent and partial distributions to be considered together.*—The rule provided in section 28 (e), that a consent distribution and a partial distribution are to be considered as having been made in connection with each other and as together forming parts of one entire distribution, is not limited to the purposes of section 28, but is applicable in connection with any of the purposes of Title I. Thus, such rule is to be applied to determine whether a partial distribution is a preferential dividend under section 27 (h). See article 27 (h)–1.

[SEC. 28. *Consent dividends credit.*]

(*f*) *Taxability of amounts specified in consents.*—The total amount specified in a consent filed under subsection (d) shall be included as a taxable dividend in the gross income of the shareholder making such consent, and, if the shareholder is taxable with respect to a dividend only if received from sources within the United States, shall be included in the computation of his tax as a dividend received from sources within the United States; regardless of—

(1) Whether he actually so includes it in his return; and

(2) Whether the distribution by the corporation of an amount equal to the total sum included in all the consents filed, had actual distribution been made, would have been in whole or in part a taxable dividend; and

(3) Whether the corporation is entitled to any consent dividends credit by reason of

the filing of such consents, or to a credit less than the total sum included in all the consents filed.

ART. 28 (f)-1. *Taxability of amounts specified in consents.*—Once a shareholder's consent is filed, the full amount specified therein shall be included in his gross income as a taxable dividend, and, in cases where the shareholder is taxable on a dividend only if received from sources within the United States, shall be treated as a dividend so received; regardless of—

(1) whether he actually so includes it in his return;

(2) whether he would have been taxable on all or any part of such amount as a dividend if it had been distributed to him in cash; and

(3) whether the corporation, as a result of filing such consents, is entitled to any consent dividends credit or to a smaller consent dividends credit than the sum of the amounts specified in the several consents.

The ground upon which a consent dividends credit is denied the corporation does not affect the taxability to a shareholder whose consent has been filed of the amount specified in his consent. Thus, he is taxable on the full amount so specified, though the corporation receives no credit or a smaller credit than the sum of the amounts specified in the consents because the corporation has no earnings and profits or a smaller amount of earnings and profits than the sum of the amounts specified in the consents. The full amount specified in a shareholder's consent which has been filed is also taxable to him as a dividend though a consent dividends credit is denied the corporation because (*a*) preferred dividends have not been paid, (*b*) part or all of the consent stock has been in a state of liquidation at any time during the taxable year, (*c*) the distribution of which the consent distribution is a part is preferential, (*d*) a consenting shareholder who is taxable with respect to a dividend only if received from sources within the United States fails to agree that the amount specified in his consent shall be considered as a dividend received by him from sources within the United States, or (*e*) payment has not been made as required by section 28 (d) (5) and article 28 (d)-1.

[SEC. 28. *Consent dividends credit.*]

(*g*) *Corporate shareholders.*—If the shareholder who makes the consent is a corporation, the amount specified in the consent shall be considered as part of its earnings or profits for the taxable year, and shall be included in the computation of its accumulated earnings and profits.

ART. 28 (g)-1. *Treatment of amount specified in consent of corporate shareholder.*—From the standpoint of computing a shareholder's income for a taxable year relative to which he has agreed to include a specific amount in gross income, such amount is treated exactly as though such shareholder had received in cash a taxable dividend equal to the amount specified in his consent. Therefore, in the case of a corporate shareholder, such amount shall be included in the computation of its earnings and profits for the taxable year and its accumulated earnings and profits as of the close of the taxable year. The effect of a corporate shareholder's consent upon the computation of its earnings and profits may be illustrated as follows:

Example: The X Corporation has one shareholder, the Y Corporation, whose consent to include $10,000 in its gross income for the calendar year 1938 has been duly made and filed. The earnings and profits of the X Corporation for the calendar year 1938 amount to only $8,000, there being at the beginning of the year 1938 no accumulated earnings or profits. The Y Corporation must nevertheless include in its gross income $10,000 as a taxable dividend. Assume the Y Corporation to have begun the year 1938 with $5,000 accumulated earnings and profits, to have made no distributions during the year, and (without considering the amount specified in its consent) to have had neither profit nor loss during the year. Its earnings and profits for the year will be $10,000 and its accumulated earnings and profits at the close of the year will be $15,000.

[SEC. 28. *Consent dividends credit.*]

(*h*) *Basis of stock in hands of shareholders.*—The amount specified in a consent made under subsection (d) shall, for the purpose of adjusting the basis of the consent stock with respect to which the consent was given, be treated as having been reinvested by the shareholder as a contribution to the capital of the corporation; but only in an amount which bears the same ratio to the consent dividends credit of the corporation as the amount of such shareholder's consent stock bears to the total amount of consent stock with respect to which consents are made.

(*i*) *Effect on capital account of corporation.*—The amount of the consent dividends credit allowed under subsection (c) shall be considered as paid in surplus or as a contribution to the capital of the corporation, and the accumulated earnings and profits as of the close of the taxable year shall be correspondingly reduced.

ART. 28 (i)-1. *Effect on basis of stock in hands of shareholders and capital account of corporation.*—The application of sections 28 (h) and 28 (i) may be illustrated by the following example:

Example: The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned entirely by A and B in equal amounts. A makes a consent to include $50 in his gross income as a dividend, but B refuses to do so. The X Corporation therefore distributes $50 to B in cash during the last month of its taxable year 1938. The consent distribution evidenced by A's consent and the actual distribution to B are treated together, as though one distribution of $100 had been made. The earnings and profits of the X Corporation for 1938, however, amount to only $80, there being at the beginning of the year 1938 no accumulated earnings or profits. If, therefore, the entire $100, which is the sum of A's consent distribution and B's actual distribution, had been actually distributed, 80 percent thereof would have been a dividend, includible in the X Corporation's basic surtax credit, and 20 percent a return of capital. Applying this principle to the facts stated, the following results are obtained:

(1) In the case of the X Corporation—

(*a*) Its consent dividends credit is $40, being 80 percent of the amount specified in A's consent;

(*b*) Its basic surtax credit, assuming it has no net operating loss in the preceding year and no bank affiliate credit, is $80, composed of a consent dividends credit of $40 and an allowance for dividends paid of $40;

(*c*) The amount of its accumulated earnings and profits as of the close of the taxable year is zero, because of the transfer of $40 (the amount of the consent dividends credit) from earnings and profits to capital account and the deduction of an additional $40 on account of dividends paid to B. If, therefore, in the following year the X Corporation has no earnings and profits but nevertheless makes a distribution to shareholders, no part of such distribution will be a dividend, but it will all constitute a return of capital.

(2) In the case of A—

(*a*) A is taxable on $50 as a dividend;

(*b*) The basis of his stock is increased by $40, his pro rata share, i. e., all, of the consent dividends credit.

(3) In the case of B—

(*a*) B is taxable on $40 as a dividend;

(*b*) The basis of his stock is reduced by $10.

[SEC. 28. *Consent dividends credit.*]

(*j*) *Amounts not included in shareholder's return.*—The failure of a shareholder of consent stock to include in his gross income for the proper taxable year the amount specified in the consent made by him and filed by the corporation, shall have the same effect, with respect to the deficiency resulting therefrom, as is provided in section 272 (f) with respect to a deficiency resulting from a mathematical error appearing on the face of the return.

CHAPTER VI

Credits Against Tax

Part III—Credits Against Tax

SEC. 31. *Taxes of foreign countries and possessions of United States.*—The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax, to the extent provided in section 131.

SEC. 32. *Taxes withheld at source.*—The amount of tax withheld at the source under section 143 or 144 shall be allowed as a credit against the tax.

SEC. 33. *Credit for overpayments.*—For credit against the tax of overpayments of taxes imposed by this title for other taxable years, see section 322.

CHAPTER VII

Accounting Periods and Methods

Part IV—Accounting Periods and Methods of Accounting

SEC. 41. *General rule.*—The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. (For use of inventories, see section 22 (c).)

ART. 41-1. *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See articles 42-1 to 42-3.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

ART. 41-2. *Bases of computation and changes in accounting methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See articles 42-2 and 42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see article 22 (c)-5.)

The true income, computed under the Act and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this article, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see articles 22 (c)-1 to 22 (c)-8); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see article 42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see articles 22 (a)-7 and 23 (a)-11). Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. See article 22 (d)-1 with respect to changing to the method of taking inventories provided in section 22 (d) in the case of producers and processors of certain nonferrous metals and in the case of tanners.

Section 44 contains special provisions for reporting the profit derived from the sale of property on the installment plan.

The foregoing requirements relative to a change of accounting method are not applicable if a taxpayer desires to adopt the installment basis of returning income, as provided in article 44-1, but are applicable if a taxpayer desires to change from such basis to a straight accrual basis. In cases where permission to make such change is granted, the taxpayer will be required to return as additional income for the taxable year in which the change is made all the profit not theretofore returned as income pertaining to the payments due on installment sales contracts as of the close of the preceding taxable year.

ART. 41-3. *Methods of accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 54 and article 54-1.) Among the essentials are the following:

(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see section 22 (c) and articles 22 (c)-1 to 22 (c)-8);

(2) Expenditures made during the year should be properly classified as between capital and expense; that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

(3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses.

ART. 41-4. *Accounting period.*—The return of a taxpayer is made and his income computed for his taxable year, which in general means his fiscal year, or the calendar year if he has not established a fiscal year. (See section 48.) The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December. No fiscal year will, however, be recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith. A person having no such fiscal year must make his return on the basis of the calendar year. Except in the case of a first return for income tax a taxpayer shall make his return on the basis upon which he made his return for the taxable year immediately preceding, unless, with the approval of the Commissioner, he has changed his accounting period. See article 46-1.

SEC. 42. *Period in which items of gross income included.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly included in respect of such period or a prior period.

ART. 42-1. *When included in gross income.*—Except as otherwise provided in section 42 in the case of the death of a taxpayer, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See articles 41-1 to 41-3.) If a taxpayer has died there shall also be included in computing net income for the taxable period in which he died amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period, regardless of the fact that the decedent may have kept his books and made his returns on the basis of cash receipts and disbursements. If no determination of compensation is had until the completion of the services, the amount received is ordinarily income for the taxable year of its determination, if the return is rendered on the accrual basis; or, for the taxable year in which received, if the return is rendered on the receipts and disbursements basis. If a person sues in one year on a pecuniary claim or for property, and money or property is recovered on a judgment therefor in a later year, income is realized in the later year, assuming that the money or property would have been income in the earlier year if then received. This is true of a recovery for patent infringement. Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. (See article 23 (k)-1.) Such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined, if the return is rendered on the accrual basis; or for the year in which received, if the return is rendered on the basis of cash receipts and disbursements.

ART. 42-2. *Income not reduced to possession.*—Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A book entry, if made, should indicate an absolute transfer from one account to another. If a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

ART. 42-3. *Examples of constructive receipt.*—If interest coupons have matured and are payable, but have not been cashed, such interest, though not collected when due and payable, shall be included in gross income for the year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year. The interest shall be included in gross income even though the coupons are exchanged for other property instead of eventually being cashed. The amount of defaulted coupons is income for the year in which paid. Dividends on corporate stock are subject to tax when unqualifiedly made subject to the demand of the shareholder. If a dividend is declared payable on December 31 and the corporation intended to and did follow its practice of paying the dividends by checks mailed so that the shareholders would not receive them until January of the following year, such dividends are not considered to have been unqualifiedly made subject to the demand of the shareholders prior to January, when the checks were actually received. As to the distributive share of the profits of a partner in a partnership, see section 188. Interest credited on savings bank deposits, even though the bank nominally has a rule, seldom or never enforced, that it may require so many days' notice before withdrawals are permitted, is income to the depositor when credited. An amount credited to shareholders of a building and loan association, when such credit passes without restriction to the shareholder, has a taxable status as income for the year of the credit. If the amount of such accumulations does not become available to the shareholder until the maturity of a share, the amount of any share in excess of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share.

ART. 42-4. *Long-term contracts.*—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this article the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(*a*) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied. If, upon completion of a contract, it is found that the taxable net income arising thereunder has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return.

(*b*) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (*a*) or (*b*) of this article only after permission is secured from the Commissioner as provided in article 41-2.

ART. 42-5. *Subtraction for redemption of trading stamps.*—If a taxpayer, for the purpose of promoting his business, issues with sales trading stamps or premium coupons redeemable in merchandise or cash, he should in computing the income from such sales subtract only the amount which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light of the experience of the taxpayer in his particular business and of other users of trading stamps or premium coupons engaged in similar businesses. The taxpayer shall file for each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, a statement showing—

(*a*) The total issue of stamps during each year;

(*b*) The total stamps redeemed in each year; and

(*c*) The rate, in percentage, which the stamps redeemed in each year bear to the total stamps issued in such year, regardless of the year when such redeemed stamps were issued.

A similar statement shall also be presented showing the experience of other users of stamps or coupons whose experience is relied upon by the taxpayer to determine the amount to be subtracted from the proceeds of sales. The Commissioner will examine the basis used in each return, and in any case in which the amount subtracted in respect of such stamps or coupons is found to be excessive, appropriate adjustment will be made.

SEC. 43. *Period for which deductions and credits taken.*—The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death of a taxpayer there shall be allowed as deductions and credits for the taxable period in which falls the date of his death, amounts accrued up to the date of his death (except deductions under section 23 (o)) if not otherwise properly allowable in respect of such period or a prior period.

ART. 43-1. *"Paid or incurred" and "paid or accrued"*—(*a*) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in Title I (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Act, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

(*b*) The provisions of paragraph (*a*) of this article in general are not applicable with respect to the taxable period during which the taxpayer dies. In such case there shall also be allowed as deductions and credits for such taxable period amounts (except deductions under section 23 (o)) accrued up to the date of his death if not otherwise allowable with respect to such period or a prior period, regardless of the fact that the decedent was required to keep his books and make his returns on the basis of cash receipts and disbursements.

ART. 43-2. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudications, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequent to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. (See section 322.) A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained.

SEC. 44. *Installment basis.*—(*a*) *Dealers in personal property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(*b*) *Sales of realty and casual sales of personalty.*—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

(*c*) *Change from accrual to installment basis.*—If a taxpayer entitled to the benefits of subsection (a) elects for any taxable year to report his net income on the installment basis, then in computing his income for the year of change or any subsequent year, amounts actually received during any such year on account of sales or other dispositions of property made in any prior year shall not be excluded.

(*d*) *Gain or loss upon disposition of installment obligations.*—If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) in the case of satisfaction at other than face value or a sale or exchange—the amount realized, or (2) in case of a distribution, transmission, or disposition otherwise than by sale or exchange—the fair market value of the obligation at the time of such distribution, transmission, or disposition. Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received. The basis of the obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full. This subsection shall not apply to the transmission at death of installment obligations if there is filed with the Commissioner, at such time as he may by regulation prescribe, a bond in such amount and with such sureties as he may deem necessary, conditioned upon the return as income, by the person receiving any payment on such obligations, of the same proportion of such payments as would be returnable as income by the decedent if he had lived and had received such payment. If an installment obligation is distributed by one corporation to another corporation in the course of a liquidation, and under section 112 (b) (6) no gain or loss with respect to the receipt of such obligation is recognized in the case of the recipient corporation, then no gain or loss with respect to the distribution of such obligation shall be recognized in the case of the distributing corporation.

ART. 44-1. *Sale of personal property on installment plan.*—Dealers in personal property ordinarily sell either for cash or on the personal credit of the purchaser or on the installment plan. Dealers who sell on the installment plan usually adopt one of four ways of protecting themselves in case of default—

(*a*) By an agreement that title is to remain in the vendor until the purchaser has completely performed his part of the transaction;

(*b*) By a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the selling price;

(*c*) By a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the vendor; or

(*d*) By conveyance to a trustee pending performance of the contract and subject to its provisions.

The general purpose and effect being the same in all of these cases, the same rule is uniformly applicable. The general rule prescribed is that a person who regularly sells or otherwise disposes of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the total or gross profit (that is, sales less cost of goods sold) realized or to be realized when the property is paid for, bears to the total contract price. Thus the income of a dealer in personal property on the installment plan may be ascertained by taking as income that proportion of the total payments received in the taxable year from installment sales (such payments being allocated to the year against the sales of which they apply) which the total or gross profit realized or to be realized on the total installment sales made during each year bears to the total contract price of all such sales made during that respective year. No payments received in the taxable year shall be excluded in computing the amount of income to be returned on the ground that they were received under a sale the total profit from which was returned as income during a taxable year or years prior to the change by the taxpayer to the installment basis of returning income. But in the case of any taxpayer who, by an original return made prior to February 26, 1926, changed the method of reporting his net income for the taxable year 1924 or any prior taxable year to the installment basis, see section 705 of the Revenue Act of 1928. Deductible items are not to be allocated to the years in which the profits from the sales of a particular year are to be returned as income, but must be deducted for the taxable year in which the items are "paid or incurred" or "paid or accrued," as provided by sections 43 and 48. A dealer who desires to compute his income on the installment basis shall maintain books of account in such a manner as to enable an accurate computation to be made on such basis in accordance with the provisions of this article.

The income from a casual sale or other casual disposition of personal property (other than property of a kind which should properly be included in inventory) may be reported on the installment basis only if (1) the sale price exceeds $1,000 and (2) the initial payments do not exceed 30 percent of the selling price.

If for any reason the purchaser defaults in any of his payments, and the vendor returning income on the installment basis repossesses the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the repossession occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the repossession or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value of the property repossessed and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the repossession. (See also article 44–5.) The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the repossession of the property shall be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the repossession, unless it is clearly shown that after the property was repossessed the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the repossession. (See also article 23 (k)–1.) If the property repossessed is bid in by the vendor at a lawful public auction or judicial sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary. The property repossessed shall be carried on the books of the vendor at its fair market value at the time of repossession.

If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible.

ART. 44–2. *Sale of real property involving deferred payments.*—Under section 44 deferred-payment sales of real property include (*a*) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (*b*) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments. Such sales, either under (*a*) or (*b*), fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of property on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made do not exceed 30 percent of the selling price;

(2) Deferred-payment sales not on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall be included as a part of the "selling price," but the amount of the mortgage, to the extent it does not exceed the basis to the vendor of the property sold, shall not be considered as a part of the "initial payments" or of the "total contract price," as those terms are used in section 44, in articles 44–1 and 44–3, and in this article. The term "initial payments" does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Commissions and other selling expenses paid or incurred by the vendor are not to be deducted or taken into account in determining the amount of the "initial payments," the "total contract price," or the "selling price." The term "initial payments" contemplates at least one other payment in addition to the initial payment. If the entire purchase price is to be paid in a lump sum in a later year, there being no payment during the first year, the income may not be returned on the installment basis. Income may not be returned on the installment basis where no payment in cash or property, other than evidences of indebtedness of the purchaser, is received during the first year, the purchaser having promised to make two or more payments in later years.

ART. 44–3. *Sale of real property on installment plan.*—In transactions included in class (1) in article 44–2 the vendor may return as income from such transactions in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price.

If the purchaser defaults in any of his payments, and the vendor returning income on the installment basis reacquires the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the reacquisition occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the reacquisition or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value of the property reacquired (including the fair market value of any fixed improvements placed on the property by the purchaser) and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the reacquisition. (See also article 44-5.) The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the reacquisition of the property will be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the reacquisition of the property, unless it is clearly shown that after the property was reacquired the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the reacquisition. (See article 23 (k)-1.) If the property reacquired is bid in by the vendor at a foreclosure sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition (including the fair market value of any fixed improvements placed on the property by the purchaser).

If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible, and the sales will be treated as deferred-payment sales not on the installment plan.

ART. 44-4. *Deferred-payment sale of real property not on installment plan.*—In transactions included in class (2) in article 44-2, the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash to the amount of their fair market value in ascertaining the profit or loss from the transaction.

If the vendor has retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property, the difference between (1) the entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser and (2) the sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser had the sale not been made will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be the original basis at the time of the sale plus the fair market value at the time of repossession, of fixed improvements placed on the property by the purchaser. If the vendor has previously transferred title to the purchaser, and the purchaser defaults in any of his payments and the vendor reacquires the property, such reacquisition shall be regarded as a transfer by the vendor, in exchange for the property, of such of the purchaser's obligations as are applied by the vendor to the purchase or bid price of the property. Such an exchange will be regarded as having resulted in the realization by the vendor of gain or loss, as the case may be, for the year of reacquisition, measured by the difference between the fair market value of the property reacquired, including the fair market value of fixed improvements placed on the property by the purchaser, and the basis in the hands of the vendor of the obligations of the purchaser (generally, the fair market value thereof which was previously recognized in computing income) which were applied by the vendor to the purchase or bid price of the property. The fair market value of the property reacquired shall be presumed to be the amount for which it is bid in by the vendor in the absence of clear and convincing proof to the contrary. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition including the fair market value of the fixed improvements placed on the property by the purchaser.

If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis as provided above and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

ART. 44-5. *Gain or loss upon disposition of installment obligations.*—The entire amount of gain or loss resulting from the disposition or satisfaction of installment obligations, computed in accordance with section 44 (d), is recognized under the Act, unless the disposition is within one of the exceptions made by the Act. Such an exception is provided in section 44 (d) with respect to distributions under section 112 (b) (6), and in section 112 (b) (4) and (5) with respect to exchanges.

The application of subsection (d) of section 44 may be illustrated by the following examples:

Example (1): In 1936 the M Corporation sold a piece of unimproved real estate to B for $20,000. The company acquired the property in 1918 at a cost of $10,000. During 1936 the company received $5,000 cash and vendee's notes for the remainder of the selling price, or $15,000, payable in subsequent years. In 1938, before the vendee made any further payments, the company sold the notes for $13,000 in cash. The corporation makes its returns on the calendar year basis. The income to be reported for 1938 is $5,500, computed as follows:

Proceeds of sale of notes		$13,000
Selling price of property	$20,000	
Cost of property	10,000	
Total profit	10,000	
Total contract price	20,000	
Percent of profit, or proportion of each payment returnable as income, $10,000 divided by $20,000, 50 percent.		
Face value of notes	15,000	
Amount of income returnable were the notes satisfied in full, 50 percent of $15,000	7,500	
Excess of face value of notes over amount of income returnable were the notes satisfied in full		7,500
Taxable income to be reported for 1938		5,500

Example (2): Suppose in the example given above the M Corporation, instead of selling the notes, distributed them in 1938 to its shareholders as a dividend, and at the time of such distribution the fair market value of the notes was $14,000. The income to be reported for 1938 is $6,500, computed as follows:

Fair market value of notes	$14,000
Excess of face value of notes over amount of income returnable were the notes satisfied in full (computed as in example (1))	7,500
Taxable income to be reported for 1938	6,500

If the taxpayer, referred to in the above examples (1) and (2) as Corporation M, had been an individual, the taxable income to be reported, shown above as $5,500 and $6,500, respectively, would have been limited to 50 percent thereof by section 117 (b), the real estate having been held for more than 24 months prior to its sale in 1936. See also section 117 (c).

In the case of decedents who die possessed of installment obligations, no gain on account of the transmission at death of such obligations is required to be reported as income in the return of the decedent for the year of his death, if the executor or administrator of the estate of the decedent or any of the next of kin or legatees files with the Commissioner a bond on Form 1132 in an amount not less than the amount by which the tax of the decedent for the year of his death would have been increased had no such bond been filed. The bond shall be conditioned upon the return as income, by any person receiving any payment in satisfaction of such obligations, of the same proportion of such payment as would be returnable as income by the decedent if he had lived and had received such payment. The bond shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds, shall be subject to the approval of the Commissioner, and must be filed at the time of filing the return of the decedent for the year of his death. See section 1126 of the Revenue Act of 1926, as amended (paragraph 35 of the Appendix to these regulations), providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States.

See section 117 as to the limitation on capital losses sustained by corporations and the limitation as to both capital gains and capital losses of individuals.

SEC. 45. *Allocation of income and deductions.*—In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

ART. 45-1. *Determination of the taxable net income of a controlled taxpayer*—(a) *Definitions.*—When used in this article—

(1) The term *"organization"* includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, or a corporation (as each is defined or understood in the Act or these regulations), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The terms *"trade"* or *"business"* include any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term *"controlled"* includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term *"controlled taxpayer"* means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms *"group"* and *"group of controlled taxpayers"* mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term *"true net income"* means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, or the item or element of either, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.*—The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, sha" determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Section 45 and this article apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate net income. If a controlled taxpayer is a party to a consolidated return, the true consolidated net income of the affiliated group and the true separate net income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

Section 45 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the Commissioner to apply such provisions. It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, or any item of either, as would produce a result equivalent to a computation of consolidated net income under section 141.

(c) *Application.*—Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income or deductions. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

SEC. 46. *Change of accounting period.*—If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 47.

ART. 46-1. *Change in accounting period.*—If a taxpayer changes his accounting period he shall, prior to the expiration of 30 days from the close of the proposed period for which a return would be required to effect the change, furnish to the collector, for transmission to the Commissioner, the information required on Form 1128. The due date of the separate return for such period is the 15th day of the third month following the close of that period. If the change is approved by the Commissioner, the taxpayer shall thereafter make his returns and compute his net income upon the basis of the new accounting period. (See section 47.)

SEC. 47. *Returns for a period of less than twelve months.*—(a) *Returns for short period resulting from change of accounting period.*—If a taxpayer, with the approval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December 31. If the change is from calendar year to fiscal year a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year.

(b) *Income computed on basis of short period.*—Where a separate return is made under subsection (a) on account of a change in the accounting period, and in all other cases where a separate return is required or permitted, by regulations prescribed by the Commissioner with the approval of the Secretary, to be made for a fractional part of a year, then the income shall be computed on the basis of the period for which separate return is made.

(c) *Income placed on annual basis.*—If a separate return is made (except returns of the income of a corporation) under subsection (a) on account of a change in the accounting period, the net income, computed on the basis of the period for which separate return is made, shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in the period for which the separate return is made. The tax shall be such part of the tax computed on such annual basis as the number of months in such period is of twelve months.

(d) *Earned income.*—The Commissioner with the approval of the Secretary shall by regulations prescribe the method of applying the provisions of subsections (b) and (c) (relating to computing income on the basis of a short period, and placing such income on an annual basis) to cases where the taxpayer makes a separate return under subsection (a) on account of a change in the accounting period, and it appears that for the period for which the return is so made he has received earned income.

(e) *Reduction of credits against net income.*—In the case of a return made for a fractional part of a year, except a return made under subsection (a), on account of a change in the accounting period, the personal exemption and credit for dependents shall be reduced respectively to amounts which bear the same ratio to the full credits provided as the number of months in the period for which return is made bears to twelve months.

(f) *Closing of taxable year in case of jeopardy.*—For closing of taxable year in case of jeopardy, see section 146.

ART. 47-1. *Returns for periods of less than 12 months.*—No return can be made for a period of more than 12 months. A separate return for a fractional part of a year is therefore required wherever there is a change, with the approval of the Commissioner, in the basis of computing net income from one taxable year to another taxable year. The periods to be covered by such separate returns in the several cases are stated in section 47 (a). The requirements with respect to the filing of a separate return and the payment of tax for a part of a year are the same as for the filing of a return and the payment of tax for a full taxable year closing at the same time. (See sections 53 and 56.) If a return is made for a fractional part of a year, except where a return is made for a period of less than 12 months by reason of a change in accounting period, the personal exemption and credit for dependents shall be reduced to that proportion of the full credit which the number of months in the period for which the return is made bears to 12 months.

In case of a change in accounting period the net income computed on the return for the fractional part of a year (except the return of a corporation) shall be placed on an annual basis and the tax computed as provided in section 47 (c).

Example: A citizen of the United States made a return for a 10-month period by reason of a change in accounting period. His net income including his earned net income for such 10-month period was $10,000, and his earned net income for such period was $4,000. He was entitled to a personal exemption of $2,500 but not to a credit for dependents. His tax for the period is $525.67, computed as follows:

Net income for 10-month period		$10,000.00
Multiplied by 12		120,000.00
Net income on annual basis ($120,000 ÷ 10)		12,000.00
Earned net income for 10-month period	$4,000.00	
Multiplied by 12	48,000.00	
Earned net income on annual basis ($48,000 ÷ 10)	4,800.00	
Subtracting:		
Earned income credit (10 percent of $4,800)	480.00	
Personal exemption	2,500.00	
		2,980.00
Net income subject to normal tax		9,020.00
Normal tax (4 percent of $9,020)		360.80
Surtax net income ($12,000 less personal exemption of $2,500)		9,500.00
Surtax on $9,500		270.00
Total tax on annual basis ($360.80 + $270)		630.80
Amount of tax for period ($630.80 × 10/12)		525.67

The return of a decedent or of his estate for the year in which he died is a return for 12 months and not for a fractional part of a year.

SEC. 48. *Definitions.*—When used in this title—

(a) *Taxable year.*—"Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. "Taxable year" includes, in the case of a return made for a fractional part of a year under the provisions of this title or under regulations prescribed by the Commissioner with the approval of the Secretary, the period for which such return is made.

(b) *Fiscal year.*—"Fiscal year" means an accounting period of twelve months ending on the last day of any month other than December.

(c) *"Paid or incurred," "Paid or accrued."*—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

(d) *Trade or business.*—The term "trade or business" includes the performance of the functions of a public office.

CHAPTER VIII

Returns and Payment of Tax

Part V—Returns and Payment of Tax

SEC. 51. *Individual returns.*—(a) *Requirement.*—The following individuals shall each make under oath a return stating specifically the items of his gross income and the deductions and credits allowed under this title and such other information for the purpose of carrying out the provisions of this title as the Commissioner with the approval of the Secretary may by regulations prescribe—

(1) Every individual who is single or who is married but not living with husband or wife, if—

(A) Having a net income for the taxable year of $1,000 or over; or

(B) Having a gross income for the taxable year of $5,000 or over, regardless of the amount of the net income.

(2) Every individual who is married and living with husband or wife, if no joint return is made under subsection (b) and if—

(A) Such individual has for the taxable year a net income of $2,500 or over or a gross income of $5,000 or over (regardless of the amount of the net income), and the other spouse has no gross income; or

(B) Such individual and his spouse each has for the taxable year a gross income (regardless of the amount of the net income) and the aggregate net income of the two is $2,500 or over; or

(C) Such individual and his spouse each has for the taxable year a gross income (regardless of the amount of the net income) and the aggregate gross income is $5,000 or over.

(b) *Husband and wife.*—In the case of a husband and wife living together the income of each (even though one has no gross income) may be included in a single return made by them jointly, in which case the tax shall be computed on the aggregate income, and the liability with respect to the tax shall be joint and several. No joint return may be made if either the husband or wife is a nonresident alien.

(c) *Persons under disability.*—If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.

(d) *Signature presumed correct.*—The fact that an individual's name is signed to a filed return shall be prima facie evidence for all purposes that the return was actually signed by him.

(e) *Fiduciaries.*—For returns to be made by fiduciaries, see section 142.

ART. 51-1. *Individual returns*—(a) *In general.*—For each taxable year a return of income shall be made by each citizen of the United States, whether residing at home or abroad, and every individual residing within the United States though not a citizen thereof, whether or not such citizen or resident is the head of a family or has dependents—

(1) If single or married but not living with husband or wife for any part of the taxable year, and if—

(*a*) having for the taxable year a gross income (as defined in sections 22 and 116) of $5,000 or over (regardless of the amount of the net income); or

(*b*) having for the taxable year a net income (as defined in section 21) of $1,000 or over.

(2) If married and living with husband or wife for the entire taxable year, if no joint return is made, and if—

(*a*) having for the taxable year a net income of $2,500 or over or a gross income of $5,000 or over (regardless of the amount of the net income), and the other spouse has no gross income; or

(*b*) such individual and his or her spouse each has for the taxable year a gross income (regardless of the amount of the net income) and the aggregate net income of the two is $2,500 or over; or

(*c*) such individual and his or her spouse each has for the taxable year a gross income (regardless of the amount of the net income) and the aggregate gross income is $5,000 or over.

(3) If married and living with husband or wife for any part of the taxable year but not at the close thereof, or if married and living with husband or wife at the close of the taxable year, but not during the entire taxable year, if no joint return is made, and if—

(*a*) having for the taxable year a net income equal to, or in excess of, the credit allowed him or her by section 25 (b) (1) and (3) (computed without regard to any credit to which he or she may be entitled as the head of a family (see article 25-7)), or a gross income of $5,000 or over (regardless of the amount of the net income) and the other spouse has no gross income; or

(*b*) such individual and his or her spouse each has for the taxable year a gross income (regardless of the amount of the net income), and the aggregate net income of the two is equal to, or in excess of, the credit allowed them by section 25 (b) (1) and (3) (computed without regard to any credit to which either or both may be entitled as the head of a family (see article 25-7)); or

(*c*) such individual and his or her spouse each has for the taxable year a gross income (regardless of the amount of the net income), and their aggregate gross income is $5,000 or over.

(*b*) *Joint returns.*—A husband and wife, if living together at the close of the taxable year, may elect to make a joint return (see section 51 (b)), that is, to include in a single return made by them jointly the income and deductions of each, even though one has no gross income. In such a case, the tax shall be computed on the aggregate income and all deductions and credits to which either is entitled shall be taken from such aggregate income. The liability with respect to the tax shall be joint and several. If one spouse dies prior to the last day of the taxable year, the surviving spouse may not include the income of the deceased spouse in a joint return for such taxable year. A joint return may not be made if either the husband or wife is a nonresident alien.

A joint return of a husband and wife (if not made by an agent other than husband or wife, see article 51-2) shall be signed by both spouses, except that one spouse may sign the return as the agent for the other, if the return is accompanied by a power of attorney on Form 936, authorizing such action. The spouse acting as agent shall, with the principal, assume the responsibility for making the return and incur liability for the penalties provided for erroneous, false, or fraudulent returns.

The joint return of a husband and wife shall be sworn to before a person duly authorized to administer oaths (see article 51-4) by the spouse preparing the return. The spouse who fills in the return shall be considered to have prepared the return within the meaning of this paragraph. If the return is prepared by both spouses, or is prepared by neither spouse, then both spouses shall swear to the return, except where one spouse acts for the other under a power of attorney submitted on Form 936, or the return is made by an agent by reason of illness or absence, as provided in article 51-2.

For returns by fiduciaries, see section 142; by partnerships, see section 187; and by nonresident alien individuals, see section 217. For time and place for filing returns, see section 53.

ART. 51-2. *Form of return.*—The return shall be on Form 1040 except that it shall be on short Form 1040A if (1) the net income does not exceed $5,000, and is derived solely from interest, dividends, annuities, and salaries, wages, commissions, bonuses, and other compensation for personal services, and (2) the taxpayer does not own a business or practice a profession on his own account and renders a return on the cash receipts and disbursements basis for the calendar year. The return shall be made on Form 1040 in all cases in which the taxpayer claims any deductions for losses from the renting of, or sale or exchange of, property. The forms may be had from the collectors of the several districts. The return may be made by an agent if, by reason of illness, the person liable for the making of the return is unable to make it. The return may also be made by an agent if the taxpayer is unable to make the return by reason of continuous absence from the United States for a period of at least 60 days prior to the date prescribed by law for making the return. Whenever a return is made by an agent it must be accompanied by the prescribed power of attorney, Form 935. The taxpayer and his agent, if any, are responsible for the return as made and incur liability for the penalties provided for erroneous, false, or fraudulent returns. For returns of nonresident aliens, see articles 217-1 and 217-2.

The home or residential address of the taxpayer (including the street and number, if any) shall be given in the space provided at the top of the return for the name and address of the taxpayer. A taxpayer having a permanent business address may give that address as the principal or mailing address, provided that the complete home or residential address is also given within the space provided.

ART. 51-3. *Return of income of minor.*—An individual, although a minor, who is single, is required to render a return of income if he has a net income of his own of $1,000 or over, or a gross income of $5,000 or over, for the taxable year. If the aggregate of the net income of such a minor from any property which he possesses, and from any funds held in trust for him by a trustee or guardian, and from his earnings which belong to him, is at least $1,000, or his gross income is at least $5,000, a return, as in the case of any other individual, must be made by him or for him by his guardian, or other person charged with the care of his person or property. (See article 142-2.) If he is married, see article 51-1. If under the laws of a State the earnings of a minor belong to the minor, such earnings, regardless of amount, are not required to be included in the return of the parent. In the absence of proof to the contrary, a parent will be assumed to have the legal right to the earnings of the minor and must include them in his return.

ART. 51-4. *Verification of returns.*—(*a*) All income tax returns must be verified under oath or affirmation. The oath or affirmation may be administered by any person duly authorized to administer oaths for general purposes by the law of the United States or of any State, Territory, or possession of the United States, or of the District of Columbia, wherein such oath or affirmation is administered, or by a consular officer of the United States. Persons in the naval or military service of the United States may verify their returns before any official authorized to administer oaths for the purposes of those respective services. Income tax returns executed abroad may be attested free of charge before United States consular officers. If a foreign notary or other foreign official having no seal should act as attesting officer, the authority of such attesting officer should be certified to by some judicial official or other proper officer having knowledge of the appointment and official character of the attesting officer.

(*b*) If any person or persons actually prepare an income return for another person, the prescribed form of affidavit on the return shall be subscribed and sworn to by such person or persons preparing the return. Such affidavit is required on all income returns required under the Act except the following:

(1) Returns required to be made by individuals on Form 1040A;

(2) Returns required under sections 143 and 144 (relating to withholding of tax at the source);

(3) Returns required to be made by departing aliens under section 146;

(4) Returns required under sections 147, 148, and 149 (relating to information at source);

(5) Returns by subsidiary corporations included in consolidated returns; and

(6) Returns required under sections 338 (a), 339, and 803 (relating to monthly information returns filed by officers and directors, and also monthly and annual information returns filed by certain shareholders, of certain foreign corporations, and returns as to the formation of foreign corporations).

Such affidavit is not required if the actual preparation of the return is a regular and usual incident of the employment of one regularly and continuously employed for full time by the person for whom the return is made (as in the case of a clerk, secretary, bookkeeper, accountant, etc.). If, however, the employee is not regularly or continuously employed by the person for whom the return is made for the full time, or the actual preparation of the return is not a regular and usual incident of such employment, the requirements of this paragraph apply. Thus, if the return is prepared by an accountant or firm of accountants making periodical audits of the accounts of the person for whom the return is prepared, the affidavit is required. If the return is a separate return of a married person, the affidavit is required, although the one actually preparing the return is the husband or wife of the taxpayer. A person who renders mere mechanical assistance or preparation as, for example, a stenographer or typist, is not considered as preparing the return. If, in the course of his official duties, a deputy collector, an internal revenue agent, or other officer or employee of the Bureau of Internal Revenue actually prepares the return, the person for whom the return is made shall make in the return a brief statement to that effect, and it will not be necessary to make the sworn statement required by this paragraph.

ART. 51-5. *Use of prescribed forms.*—Copies of the prescribed return forms will so far as possible be furnished taxpayers by collectors. A taxpayer will not be excused from making a return, however, by the fact that no return form has been furnished to him. Taxpayers not supplied with the proper forms should make application therefor to the collector in ample time to have their returns prepared, verified, and filed with the collector on or before the due date. Each taxpayer should carefully prepare his return so as fully and clearly to set forth the data therein called for. Returns which have not been so prepared will not be accepted as meeting the requirements of the Act. In lack of a prescribed form a statement made by a taxpayer disclosing his gross income and the deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time the statement so made will relieve the taxpayer from liability to penalties, provided that without unnecessary delay such a tentative return is supplemented by a return made on the proper form. (See further articles 53-2 to 53-4.)

SEC. 52. *Corporation returns.*—Every corporation subject to taxation under this title shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title and such other information for the purpose of carrying out the provisions of this title as the Commissioner with the approval of the Secretary may by regulations prescribe. The return shall be sworn to by the president, vice president, or other principal officer and by the treasurer, assistant treasurer, or chief accounting officer. In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.

ART. 52-1. *Corporation returns.*—Every corporation not expressly exempt from tax must make a return of income, regardless of the amount of its net income. In the case of ordinary corporations, the return shall be on Form 1120 or Form 1120A. For returns of insurance companies, see articles 201 (b)-1, 204 (a)-1, and 207-7; of foreign corporations, see section 235; and of affiliated corporations, see section 141 and article 141-1. A corporation having an existence during any portion of a taxable year is required to make a return. A corporation which has received a charter, but has never perfected its organization, which has transacted no business, and had no income from any source, may upon presentation of the facts to the collector be relieved from the necessity of making a return as long as it remains in an unorganized condition. In the absence of a proper showing to the collector such a corporation will be required to make a return. A corporation which was dissolved in 1938 prior to the enactment of the Revenue Act of 1938 is not relieved from the necessity of rendering returns thereunder for any period or periods of its existence for which the Act is effective. For information returns by corporations contemplating dissolution or liquidation, see section 148 (d). For information returns by corporations of distributions in liquidation, see section 148 (e). For information returns by corporations relating to profits of the taxable year declared as dividends, see section 148 (b). For verification of returns and use of prescribed forms, see articles 51-4 and 51-5.

ART. 52-2. *Returns by receivers.*—Receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income for such corporations. If a receiver has full custody of and control over the business or property of a corporation, he shall be deemed to be operating such business or property within the meaning of section 52, whether he is engaged in carrying on the business for which the corporation was organized or only in marshaling, selling, and disposing of its assets for purposes of liquidation. Notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee, or assignee, subject to the order of the court, such receiver, trustee, or assignee stands in the place of the corporate officers and is required to perform all the duties and assume all the liabilities which would devolve upon the officers of the corporation were they in control. (See sections 274 and 298 and articles 274-1 and 274-2.) A receiver in charge of only part of the property of a corporation, however, as, for example, a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income.

SEC. 53. *Time and place for filing returns.*—(a) *Time for filing.*—(1) *General rule.*—Returns made on the basis of the calendar year shall be made on or before the 15th day of March following the close of the calendar year. Returns made on the basis of a fiscal year shall be made on or before the 15th day of the third month following the close of the fiscal year.

(2) *Extension of time.*—The Commissioner may grant a reasonable extension of time for filing returns, under such rules and regulations as he shall prescribe with the approval of the Secretary. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) *To whom return made.*—(1) *Individuals.*—Returns (other than corporation returns) shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

(2) *Corporations.*—Returns of corporations shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

ART. 53-1. *Time for filing returns.*—Returns of income (except in the case of nonresident alien individuals, as to which see section 217, and foreign corporations, as to which see section 235) must be made on or before the 15th day of the third month following the close of the taxable year. A corporation going into liquidation during any taxable year may, upon the completion of such liquidation, prepare a return for that year covering its income for the part of the year during which it was engaged in business and may immediately file such return with the collector. See also section 148 (d) and (e).

ART. 53-2. *Extensions of time for filing returns.*—It is important that the taxpayer render on or before the due date a return as nearly complete and final as it is possible for him to prepare. However, the Commissioner is authorized to grant a reasonable extension of time for filing returns under such rules and regulations as he shall prescribe with the approval of the Secretary. Accordingly, authority for granting extensions of time for filing income tax returns is hereby delegated to the various collectors of internal revenue. Application for extensions of time for filing income tax returns should be addressed to the collector of internal revenue for the district in which the taxpayer files his returns and must contain a full recital of the causes for the delay. Except in the case of taxpayers who are abroad, no extension for filing income tax returns may be granted for more than six months. For extensions of time for payment of tax, see sections 56 (c) and 272 (j) and articles 53-3, 56-2, and 272-3.

ART. 53-3. *Extensions of time in the case of foreign organizations, certain domestic corporations, and citizens of United States residing or traveling abroad.*—An extension of time for filing returns of income for taxable years begun after December 31, 1937, is hereby granted up to and including the 15th day of the sixth month following the close of the taxable year in the case of:

(*a*) Foreign partnerships regardless of whether they maintain an office or place of business within the United States;

(*b*) Foreign corporations which maintain an office or place of business within the United States;

(*c*) Domestic corporations which transact their business and keep their records and books of account abroad;

(*d*) Domestic corporations whose principal income is from sources within the possessions of the United States; and

(*e*) American citizens residing or traveling abroad, including persons in military or naval service on duty outside the United States.

In all such cases an affidavit must be attached to the return, stating the cause of the delay in filing.

Taxpayers who take advantage of this extension of time will be charged with interest at the rate of 6 percent per annum on the first installment of tax from the original due date until paid.

ART. 53-4. *Due date of return.*—The due date is the date on or before which a return is required to be filed in accordance with the provisions of the Act or the last day of the period covered by an extension of time granted by the Commissioner or a collector. When the due date falls on Sunday or a legal holiday, the due date for filing returns will be the day following such Sunday or legal holiday. If placed in the mails, the returns should be posted in ample time to reach the collector's office, under ordinary handling of the mails, on or before the date on which the return is required to be filed. If a return is made and placed in the mails in due course, properly addressed and postage paid, in ample time to reach the office of the collector on or before the due date, no penalty will attach should the return not actually be received by such officer until subsequent to that date. If a question may be raised as to whether the return was posted in ample time to reach the collector's office on or before the due date, the envelope in which the return was transmitted will be preserved by the collector and forwarded to the Commissioner with the return. As to additions to the tax in the case of failure to file return within the prescribed time, see section 291.

ART. 53-5. *Place for filing individual returns.*—Section 53 (b) (1) provides that individual returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Md.

An individual employed on a salary or commission basis who is not also engaged in conducting a commercial or professional enterprise for profit on his own account does not have a "principal place of business" within the meaning of section 53 (b) (1), and shall make his return to the collector for the district in which is located his legal residence, or, if he has no legal residence in the United States, then to the collector at Baltimore, Md.

SEC. 54. *Records and special returns.*—(*a*) *By taxpayer.*—Every person liable to any tax imposed by this title or for the collection thereof, shall keep such records, render under oath such statements, make such returns, and comply with such rules and regulations, as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

(*b*) *To determine liability to tax.*—Whenever in the judgment of the Commissioner necessary he may require any person, by notice served upon him, to make a return, render under oath such statements, or keep such records, as the Commissioner deems sufficient to show whether or not such person is liable to tax under this title.

(*c*) *Information at the source.*—For requirement of statements and returns by one person to assist in determining the tax liability of another person, see sections 147 to 150.

(*d*) *Copies of returns.*—If any person, required by law or regulations made pursuant to law to file a copy of any income return for any taxable year, fails to file such copy at the time required, there shall be due and assessed against such person $5 in the case of an individual return or $10 in the case of a fiduciary, partnership, or corporation return, and the collector with whom the return is filed shall prepare such copy. Such amount shall be collected and paid, without interest, in the same manner as the amount of tax due in excess of that shown by the taxpayer upon a return in the case of a mathematical error appearing on the face of the return. Copies of returns filed or prepared pursuant to this subsection shall remain on file for a period of not less than two years from the date they are required to be filed, and may be destroyed at any time thereafter under the direction of the Commissioner.

(*e*) *Foreign personal holding companies.*—For information returns by officers, directors, and large shareholders, with respect to foreign personal holding companies, see sections 338, 339, and 340.

ART. 54-1. *Records and income tax forms.*—Every person subject to the tax, except persons whose gross income (1) consists solely of salary, wages, or similar compensation for personal services rendered, or (2) arises solely from the business of growing and selling products of the soil, shall, for the purpose of enabling the Commissioner to determine the correct amount of income subject to the tax, keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of the gross income and the deductions, credits, and other matters required to be shown in any return under Title I of the Act. Such books or records shall be kept at all times available for inspection by internal-revenue officers, and shall be retained so long as the contents thereof may become material in the administration of any internal-revenue law.

Income-tax forms shall be prescribed by the Commissioner and shall be executed and filed in accordance with these regulations and the instructions on the form or issued therewith.

SEC. 55. *Publicity of returns.*—(*a*) Returns made under this title shall be open to inspection in the same manner, to the same extent, and subject to the same provisions of law, including penalties, as returns made under Title II of the Revenue Act of 1926; and all returns made under this Act shall constitute public records and shall be open to public examination and inspection to such extent as shall be authorized in rules and regulations promulgated by the President.

(*b*) (1) All income returns filed under this title (or copies thereof, if so prescribed by regulations made under this subsection), shall be open to inspection by any official, body, or commission, lawfully charged with the administration of any State tax law, if the inspection is for the purpose of such administration or for the purpose of obtaining information to be furnished to local taxing authorities as provided in paragraph (2). The inspection shall be permitted only upon written request of the Governor of such State, designating the representative of such official, body, or commission to make the inspection on behalf of such official, body, or commission. The inspection shall be made in such manner, and at such times and places, as shall be prescribed by regulations made by the Commissioner with the approval of the Secretary.

(2) Any information thus secured by any official, body, or commission of any State may be used only for the administration of the tax laws of such State, except that upon written request of the Governor of such State any such information may be furnished to any official, body, or commission of any political subdivision of such State, lawfully charged with the administration of the tax laws of such political subdivision, but may be furnished only for the purpose of, and may be used only for,

the administration of such tax laws. Any officer, employee, or agent of any State or political subdivision, who divulges (except as authorized in this subsection, or when called upon to testify in any judicial or administrative proceeding to which the State or political subdivision, or such State or local official, body, or commission, as such, is a party) any information acquired by him through an inspection permitted him or another under this subsection shall be guilty of a misdemeanor and shall upon conviction be punished by a fine of not more than $1,000, or by imprisonment for not more than one year, or both.

ART. 55 (b)-1. *Definitions.*—Any word or term used in this article and articles 55 (b)-2 to 55 (b)-5, inclusive, which is defined in the Act shall be given the respective definition contained in the Act.

ART. 55 (b)-2. *Copies of income returns.*—Every person (except nonresident alien individuals, nonresident alien fiduciaries, nonresident foreign partnerships, and nonresident foreign corporations) required to file an income return (including affiliation schedules) under the provisions of section 51, 52, 141, 142, or 187 of Title I, or Title IA, or section 602 of Title III, shall file with the return a copy thereof on a duplicate form on colored paper which will be provided for that purpose. The copy on such duplicate form shall be a complete duplicate of the return as filed except that the affidavits on the duplicate form need not be filled in. There shall be attached to the copy on the duplicate form a copy of any schedule or statement attached to the original return except (1) Schedule H-1 in the case of a corporation return, (2) the copy of the will or trust instrument in the case of a fiduciary return, (3) the power of attorney on Form 935 or Form 936 in the case of a return made by an agent, and (4) the copy of the annual statement made to the insurance department of the State, Territory, or District of Columbia in the case of a return of an insurance company. In lieu of filling in the duplicate form on colored paper, a legible photostat or photograph of the return and related schedules as filed may be filed with the return provided such photostat or photograph is not of larger dimensions than the return and is securely fastened to the duplicate form. For amounts to be assessed and collected in the case of the failure to file a copy of any income return required by law or regulations, see section 54 (d).

ART. 55 (b)-3. *Inspection of copies of returns.*—Within a reasonable time after the returns are filed the copies thereof (including photostats and photographs), under such procedure as may be prescribed by the Commissioner, shall be made available for inspection in the office of the collector of internal revenue in which the returns are filed, by any official, body, or commission, lawfully charged with the administration of any State tax law, or by the representatives of such official, body, or commission designated in writing by the governor of the State, for the purpose of such administration or for the purpose of obtaining information to be furnished to local taxing authorities as provided in section 55 (b) (2). The governors of the respective States shall be notified by the Commissioner of the date the copies of the returns are available for inspection and inspection thereof shall not be permitted after one year from such date.

ART. 55 (b)-4. *Request for permission to inspect copies.*—Requests for permission to inspect the copies of returns must be in writing signed by the governor under the seal of his State, and must be addressed to the Commissioner of Internal Revenue, Records Division, Washington, D. C. The request must state (*a*) the kind of returns it is desired to inspect, (*b*) the taxable year or years covered by the copies of returns it is desired to inspect, (*c*) the name of the official, body, or commission by whom or which the inspection is to be made, (*d*) the name of the representative of such official, body, or commission, designated to make the inspection, (*e*) by specific references, the State tax law which such official, body, or commission is charged with administering and the law under which he, she, or it is so charged, (*f*) the purpose for which the inspection is to be made, and (*g*) if the inspection is for the purpose of obtaining information to be furnished to local taxing authorities, (1) the name of the official, body, or commission of any political subdivision of the State, lawfully charged with the administration of the tax laws of such political subdivision, if any, to whom or to which the information secured by the inspection is to be furnished, and (2) the purpose for which the information is to be used by such official, body, or commission.

ART. 55 (b)-5. *Inspection of original returns.*—In addition to the inspection of copies of returns provided for in article 55 (b)-3, any properly authorized official, body, or commission, lawfully charged with administration of any State tax law, or properly designated representatives of such official, body, or commission, may, in the discretion of the Commissioner, inspect original income returns for any taxable year ending on or after July 31, 1938, for the purpose of such administration. For the purposes of this article the word "returns" shall include information returns, schedules, lists, and other written statements filed with the Commissioner designed to be supplemental to or to become a part of income returns. When permission to inspect original returns is requested, the application of the governor of the State shall conform to the requirements specified in article 55 (b)-4.

In any case where inspection of the original returns is authorized in accordance with the provisions of this article, the Commissioner may, in his discretion, permit inspection of other records and reports which contain information included or required by statute to be included in the return.

For inspection of returns, other than on behalf of States or political subdivisions thereof, and furnishing copies of returns so open to inspection, see Treasury Decision 4873, approved by the President on November 12, 1938, and Treasury Decision 4878, approved January 4, 1939 (pages 699 and 710 of the Appendix to these regulations).

SEC. 56. *Payment of tax.*—(*a*) *Time of payment.*—The total amount of tax imposed by this title shall be paid on the fifteenth day of March following the close of the calendar year, or, if the return should be made on the basis of a fiscal year, then on the fifteenth day of the third month following the close of the fiscal year.

(*b*) *Installment payments.*—The taxpayer may elect to pay the tax in four equal installments, in which case the first installment shall be paid on the date prescribed for the payment of the tax by the taxpayer, the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after such date. If any installment is not paid on or before the date fixed for its payment, the whole amount of the tax unpaid shall be paid upon notice and demand from the collector.

(*c*) *Extension of time for payment.*—(1) *General rule.*—At the request of the taxpayer, the Commissioner may extend the time for payment of the amount determined as the tax by the taxpayer, or any installment thereof, for a period not to exceed six months from the date prescribed for the payment of the tax or an installment thereof. In such case the amount in respect of which the extension is granted shall be paid on or before the date of the expiration of the period of the extension.

(2) *Liquidation of personal holding companies.*—At the request of the taxpayer, the Commissioner may (under regulations prescribed by the Commissioner with the approval of the Secretary) extend (for a period not to exceed five years from the date prescribed for the payment of the tax) the time for the payment of such portion of the amount determined as the tax by the taxpayer as is attributable to the short-term or long-term capital gain derived by the taxpayer from the receipt by him of property other than money upon the complete liquidation (as defined in section 115 (c)) of a corporation. This paragraph shall apply only if the corporation, for its taxable year preceding the year in which occurred the complete liquidation (or the first of the series of distributions referred to in such section), was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company. An extension under this paragraph shall be granted only if it is shown to the satisfaction of the Commissioner that the failure to grant it will result in undue hardship to the taxpayer. If an extension is granted the amount with respect to which the extension is granted shall be paid on or before the date of the expiration of the extension. If an extension is granted under this paragraph the Commissioner may require the taxpayer to furnish a bond in such amount, not exceeding double the amount with respect to which the extension is granted, and with such sureties as the Commissioner deems necessary, conditioned upon the payment of the amount with respect to which the extension is granted in accordance with the terms of the extension.

(*d*) *Voluntary advance payment.*—A tax imposed by this title, or any installment thereof, may be paid, at the election of the taxpayer, prior to the date prescribed for its payment.

(e) *Advance payment in case of jeopardy.*—For advance payment in case of jeopardy, see section 146.

(f) *Tax withheld at source.*—For requirement of withholding tax at the source in the case of nonresident aliens and foreign corporations, and in the case of so-called "tax-free covenant bonds", see sections 143 and 144.

(g) *Fractional parts of cent.*—In the payment of any tax under this title a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent.

(h) *Receipts.*—Every collector to whom any payment of any income tax is made shall upon request give to the person making such payment a full written or printed receipt therefor.

ART. 56-1. *Date on which tax shall be paid.*—The tax, unless it is required to be withheld at the source (see sections 143 and 144) or unless it is to be paid by a nonresident alien individual (see section 218) or a foreign corporation not having any office or place of business in the United States (see section 236), is to be paid on or before the 15th day of March following the close of the calendar year, or, if the return is made on the basis of a fiscal year, on or before the 15th day of the third month following the close of such fiscal year. But see article 53-3. The tax may, at the option of the taxpayer, be paid in four equal installments instead of in a single payment, in which case the first installment is to be paid on or before the date prescribed for the payment of the tax as a single payment, the second installment on or before the 15th day of the third month, the third installment on or before the 15th day of the sixth month, and the fourth installment on or before the 15th day of the ninth month, after such date. If the taxpayer elects to pay the tax in four installments, each of the four installments must be equal in amount, but any installment may be paid, at the election of the taxpayer, prior to the date prescribed for its payment. If an installment is not paid in full on or before the date fixed for its payment either by the Act or by the Commissioner in accordance with the terms of an extension, the whole amount of the tax unpaid shall be paid upon notice and demand from the collector.

ART. 56-2. *Extension of time for payment of the tax or installment thereof.*—If it is shown to the satisfaction of the Commissioner that the payment of the amount determined as the tax by the taxpayer or any part or installment thereof upon the date or dates prescribed for the payment thereof will result in undue hardship to the taxpayer, the Commissioner, at the request of the taxpayer, may grant an extension of time for the payment for a period not to exceed six months from the date prescribed for the payment of such amount, part, or installment, except that the extension may be for a period not to exceed five years from the date prescribed for the payment of the tax in the case of such portion of the amount determined as the tax by the taxpayer which is attributable to the short-term or long-term capital gain derived by the taxpayer from the receipt by him of property other than money upon the complete liquidation (as defined in section 115 (c) of a corporation if the corporation, for its taxable year preceding the year in which occurred the complete liquidation (or the first of the series of distributions referred to in section 115 (c)), was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company. An extension will not be granted upon a general statement of hardship. The term "undue hardship" means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, due to the sale of property at a sacrifice price, will result to the taxpayer from making payment of the amount at the due date. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.

An application for an extension of time for the payment of such tax should be made under oath on Form 1127 and must be accompanied or supported by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. A sworn statement of assets and liabilities of the taxpayer and an itemized statement under oath showing all receipts and disbursements for each of the three months immediately preceding the due date of the tax are required and should accompany the application. The application, with the evidence, must be filed with the collector, who will transmit it to the Commissioner with his recommendations as to the extension. When it is received by the Commissioner, it will be examined and, if possible, within 30 days will be denied, granted, or tentatively granted, subject to certain conditions of which the taxpayer will be notified. The Commissioner will not consider an application for an extension of time for the payment of a tax unless request therefor is made to the collector on or before the date prescribed for payment of the tax or installment thereof for which the extension is desired, or on or before the date or dates prescribed for payment in any prior extension granted.

As a condition to the granting of such an extension, the Commissioner will usually require the taxpayer to furnish a bond on Form 1130 in an amount not exceeding double the amount of the tax or to furnish other security satisfactory to the Commissioner for the payment of the tax, or installment thereof, on or before the date or dates prescribed for payment in the extension, so that the risk of loss to the Government will not be greater at the end of the extension period than it was at the beginning of the period. If a bond is required it shall be conditioned upon the payment of the tax, interest, and additional amounts assessed in connection therewith in accordance with the terms of the extension granted, and shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds, and shall be subject to the approval of the Commissioner. In lieu of such a bond, the taxpayer may file a bond secured by deposit of bonds or notes of the United States equal in their total par value to an amount not exceeding double the amount of the tax, or installment thereof. (See section 1126 of the Revenue Act of 1926, as amended, paragraph 35 of the Appendix to these regulations.) A request by the taxpayer for an extension of time for the payment of one installment does not operate to procure an extension of time for payment of subsequent installments. Nor does an extension of time for filing a return operate to extend the time for the payment of the tax or any part thereof, unless so specified in the extension. If an extension of time for payment of the tax or any installment is granted, the amount, time for payment of which is so extended, shall be paid on or before the expiration of the period of the extension, together with interest at the rate of 6 percent per annum on such amount from the date when the payment should have been made if no extension had been granted until the expiration of the period of the extension. (See section 295.)

ART. 56-3. *When fractional part of cent may be disregarded.*—In the payment of taxes a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent. Fractional parts of a cent should not be disregarded in the computation of taxes.

ART. 56-4. *Receipts for tax payments.*—Upon request a collector will give a receipt for each tax payment. In the case of payments made by check or money order the canceled check or the money order receipt is usually a sufficient receipt. In the case of payments in cash, however, the taxpayer should in every instance require and the collector should furnish a receipt.

SEC. 57. *Examination of return and determination of tax.*—As soon as practicable after the return is filed the Commissioner shall examine it and shall determine the correct amount of the tax.

ART. 57-1. *Examination of return and determination of tax by the Commissioner.*—As soon as practicable after returns are filed, they will be examined and the correct amount of the tax determined under such procedure as may be prescribed from time to time by the Commissioner. (See section 272.)

SEC. 58. *Additions to tax and penalties.*—(a) For additions to the tax in case of negligence or fraud in the nonpayment of tax or failure to file return therefor, see Supplement M.

(b) For criminal penalties for nonpayment of tax or failure to file return therefor, see section 145.

SEC. 59. *Administrative proceedings.*—For administrative proceedings in respect of the nonpayment or overpayment of a tax imposed by this title, see as follows:

(a) Supplement L, relating to assessment and collection of deficiencies.

(b) Supplement M, relating to interest and additions to tax.

(c) Supplement N, relating to claims against transferees and fiduciaries.

(d) Supplement O, relating to overpayments.

CHAPTER IX

Miscellaneous Provisions

Part VI—Miscellaneous Provisions

SEC. 61. *Laws made applicable.*—All administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this title.

SEC. 62. *Rules and regulations.*—The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this title.

SEC. 63. *Taxes in lieu of taxes under 1936 Act.*—The taxes imposed by this title and Title IA shall be in lieu of the taxes imposed by Titles I and IA of the Revenue Act of 1936, as amended.

[*Chapters X–XXXIII (Supplemental Provisions, Subtitle C of Title I) will appear in the "Federal Register" for Saturday, February 11, 1939. Chapters XXXIV–XXXVIII and the Appendix will appear in the "Federal Register" for Tuesday, February 14, 1939.*]

[SEAL] GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved, February 7, 1939.

H. MORGENTHAU, Jr.
Secretary of the Treasury.

[F. R. Doc. 39–450; Filed, February 7, 1939; 4:01 p. m.]

Notices

TREASURY DEPARTMENT.

Federal Alcohol Administration Division.

PURCHASING CAPITAL STOCK IN RETAIL CORPORATION

FEBRUARY 8, 1939.

To all Industry Members:

The Administration is in receipt of inquiries from the trade as to whether or not, under the Federal Alcohol Administration Act, industry members subject to the Administration's jurisdiction may acquire and hold stock in a corporation engaged in business as a retail liquor dealer. In view of the fact that the acquisition of a part of the capital stock of a corporation engaged in retailing alcoholic beverages would automatically convey to the purchaser thereof an interest in the property of the retailer, the Administration has concluded that the provisions of section 5 (b) of the Federal Alcohol Administration Act would be applicable to such transactions.

It follows that if the acquiring or holding of such an interest operates to affect the purchasing policies of the retail corporation, in the manner proscribed by the statute, a violation of the statute would result.

[SEAL] W. S. ALEXANDER,
Administrator.

[F. R. Doc. 39–466; Filed, February 8, 1939; 3:55 p. m.]

DEPARTMENT OF AGRICULTURE.

Agricultural Adjustment Administration.

[NCR–351–J]

1939 JONES COUNTY, SOUTH DAKOTA, RANGE CONSERVATION PROGRAM BULLETIN

CONTENTS

This bulletin sets forth provisions for continuing the special range conservation program administered in Jones County, South Dakota, in 1938 as the first of three years during which the program was designed to operate. That program prescribed "provisions for establishing an individual range-building goal to be attained as quickly as possible and at least by the end of three years, and yearly cumulative goals which should be attained by the end of each respective year and which accumulate to equal the three-year range-building goal. Subject to the provisions of this bulletin and within the yearly range-building allowance, payment will be made for the attainment of these separate yearly goals. Goals in all cases include the retention of 20 percent of the annual growth of palatable forage at the end of the grazing season, the showing of performance of a designated quantity of practices listed in this bulletin, and may include at the discretion of the committee the performance of additional nonlisted range-building practice considered essential to the conservation of the range land in the ranching unit. All payments are contingent upon the attaining of the yearly cumulative goal; there is no provision for partial performance. For those ranches for which the number of units of listed practices in the cumulative goal for the year in question is no larger than the number of units of such practices in the cumulative goal for the previous year, a payment of 75 percent of the annual range-building allowance will be made, provided the requirements of the goal for that year are met."

Pursuant to the authority vested in the Secretary of Agriculture under Sections 7 to 17, inclusive, of the Soil Conservation and Domestic Allotment Act (49 Stat. 1148), as amended, and in connection with the effectuation of the purposes of Section 7 (a) of said Act in 1939, payments will be made for participation in the 1939 Jones County Range Conservation Program in accordance with the provisions hereof and such modifications therof or other revisions as may hereafter be made.

The provisions of this program are necessarily subject to such legislation affecting said program as the Congress of the United States may hereafter enact; the making of the payments herein provided is contingent upon such appropriation as the Congress may hereafter provide for such purpose; and the amounts of such payments will necessarily be within the limits finally determined by such appropriation, the apportionment of such appropriation under the provisions of the Soil Conservation and Domestic Allotment Act, as amended, and such payments may be increased or decreased by not more than 10 percent, depending upon the extent of participation in the 1939 Range Conservation Program.

The provisions of the 1939 Jones County, South Dakota, Range Conservation Program contained in this Bulletin are not applicable (1) to counties other than Jones County, South Dakota, and (2) to public domain of the United States, and other lands in which the beneficial ownership is in the United States.

The provisions of this bulletin are to be renewed in 1940 except in case the Agricultural Adjustment Administration finds that (1) the national range program has been modified in such manner as to adopt the essential provisions of the Jones County, South Dakota, Program or is otherwise modified in such manner as to indicate a continuation of the Jones County Program is unnecessary or undesirable, or (2) the resulting performance under this program has proven it is not administratively feasible, and that it is not contributing to the improvement of the national range program, or for other reasons indicates its continuation is undesirable, or (3) modifications of the Soil Conservation and Domestic Allotment Act, as amended, or the Agricultural Adjustment Act of 1938, as amended, are such as to prohibit its continuation, or are such as to indicate its continuation is not administratively advisable.

SECTION I. *Range-building allowance.*—The range-building allowance shall be $1.40 times the grazing capacity (expressed as animal units) of the range land in the ranching unit, provided, that this item shall not be calculated on more

FEDERAL REGISTER

THE NATIONAL ARCHIVES OF THE UNITED STATES 1934

VOLUME 4 NUMBER 29

Washington, Saturday, February 11, 1939

The President

EXECUTIVE ORDER

AUTHORIZING THE APPOINTMENT OF FREDERICK MORGAN DAVENPORT TO A CLASSIFIED POSITION IN THE CIVIL SERVICE COMMISSION AND DESIGNATING HIM AS A MEMBER AND CHAIRMAN OF THE COUNCIL OF PERSONNEL ADMINISTRATION

By virtue of and pursuant to the authority vested in me by paragraph Eighth, subdivision SECOND, section 2 of the Civil Service Act (22 Stat. 403, 404), and as President of the United States, it is hereby ordered that Frederick Morgan Davenport may be appointed to a classified position in the Civil Service Commission; and I hereby designate the said Frederick Morgan Davenport as a member and Chairman of the Council of Personnel Administration established by section 7 of Executive Order No. 7916 of June 24, 1938,[1] such designation to become effective upon his acceptance of the appointment herein authorized.

FRANKLIN D ROOSEVELT

THE WHITE HOUSE
February 8, 1939.

[No. 8045]

[F. R. Doc. 39-476; Filed, February 9, 1939; 2:49 p. m.]

Rules, Regulations, Orders

TITLE 16—COMMERCIAL PRACTICES

FEDERAL TRADE COMMISSION

[Docket No. 3232]

IN THE MATTER OF AMERICAN OPTICAL COMPANY ET AL.

SEC. 3.45 (e) (2) *Discriminating in price—Indirect discrimination—Cumulative discounts.*—Discriminating in price, in connection with distribution and sale of optical and ophthalmic products in commerce between the states and in District of Columbia, and on the part of respondent association and respondent corporation, their officers, etc., between different purchasers of such products of like grade and quality, by (a) granting or allowing, under respondents' "big dealer" (retailer) discount plan, cumulative or volume discounts on stock lenses, frames and mountings (items or types in greatest demand and making up bulk of purchases of respondents' customers), on basis certain monthly or yearly aggregate purchases of all items included, whether themselves subject or not to such discounts, and irrespective of size or number of orders thus aggregated, and including among said items last referred to as not themselves subject to such discounts, prescription purchases and purchase of machinery and ophthalmological equipment; or by (b) continuing in effect, as described, respondents' "big dealer" (retailer) discount plan, differentials of which plan failed to make only due allowances for or to bear any consistent relation to differences, if any, in cost of sale or delivery of stock merchandise resulting from the differing quantities in which sale and delivery is made to different customers under said plan; with result that, while substantial number of respondents' customers were able to secure discounts provided in their "big dealer" discount schedule, many other customers, engaged in competition with such "big dealers" in use and sale of respondents' said products, did not receive benefit of such discounts, and with result that effect of such discrimination in price had been to injure and might be to injure, destroy or prevent competition with respondents' retailer customers receiving benefit of such discrimination, and effect thereof was and might be substantially to lessen competition or tend to create a monopoly in the line of commerce in which respondents were engaged, or to injure, destroy or prevent competition with respondents in both the wholesale and manufacturing fields; prohibited. (Sec. 2 (a), 59 Stat. 1526; 15 U. S. C., Supp. IV, Sec. 13 (a)) [Cease and desist order, American Op-

[1] 3 F. R. 1526 DI.

CONTENTS

(Continued on next page)

TITLE 26—INTERNAL REVENUE

BUREAU OF INTERNAL REVENUE

[Regulations 101]

INCOME TAX UNDER THE REVENUE ACT OF 1938

[*The Table of Contents and Chapters I-IX appeared in the Federal Register for Friday, February 10, 1939.*]

CHAPTER X

Corporations Exempt From Tax

Subtitle C—Supplemental Provisions, Supplement A—Rates of Tax (Supplementary to Subtitle B, Part I)

SEC. 101. *Exemptions from tax on corporations.*—The following organizations shall be exempt from taxation under this title—

ART. 101-1. *Proof of exemption.*—A corporation is not exempt merely because it is not organized and operated for profit. In order to establish its exemption and thus be relieved of the duty of filing returns of income and paying the tax, it is necessary that every organization claiming exemption file an affidavit with the collector of the district in which it is located, showing the character of the organization, the purpose for which it was organized, its actual activities, the sources of its income and the disposition of such income, whether or not any of its income is credited to surplus or may inure to the benefit of any private shareholder or individual, and in general all facts relating to its operations which affect its right to exemption. To such affidavit should be attached a copy of the charter or articles of incorporation, the by-laws of the organization, and the latest financial statement, showing the assets, liabilities, receipts, and disbursements of the organization. The words "private shareholder or individual" in section 101 refer to individuals having a personal and private interest in the activities of the corporation. Although religious or apostolic associations or corporations exempt under section 101 (18) are relieved from paying the tax, they are required to file returns of income (see article 101 (18)-1).

In the case of the particular classes of organizations listed below, the following additional information should be embodied in or attached to, and made a part of, the affidavit referred to above:

(1) Fraternal beneficiary societies, orders, or associations: (*a*) The number of subordinate lodges in active operation, (*b*) whether periodical meetings are actually held;

(2) Building and loan associations and cooperative banks: These associations and banks shall submit the information required by Questionnaire, Form 1027, copies of which may be obtained from any collector;

(3) Corporations, community chests, funds, or foundations claiming exemption under section 101 (6): To what extent the activities of the organization involve carrying on propaganda, or otherwise attempting, to influence legislation;

(4) Educational organizations: In addition to the information called for in (3) above, whether any of the shareholders are paid by the organization, and if so, the reason for each such payment and the amount thereof;

(5) Hospitals: In addition to the information called for in (3) above, whether part-pay or non-pay patients are accepted and whether the amounts paid by part-pay patients are more than nominal;

(6) Business leagues: (*a*) A statement of the services performed for members, (*b*) a statement of the services performed for nonmembers;

(7) Clubs: The income received from the use of the facilities by the general public;

(8) Benevolent life insurance associations: (*a*) The number of counties in which the association accepts risks, (*b*) copies of the policies or certificates of membership;

(9) Mutual insurance companies: (*a*) Copies of the policies or certificates of membership; (*b*) if any substantial amount of income is claimed to be held for the payment of losses or expenses, a statement based upon a reliable table of loss experience demonstrating that the amount so held for the payment of losses is reasonably necessary; or in the case of expenses, a statement based upon reliable statistics showing that the expenses were incurred or that in all probability they will be incurred;

(10) Farmers' cooperative associations: These associations shall submit the information required by Questionnaire, Form 1028, copies of which may be obtained from any collector;

(11) Holding companies: (*a*) The name of the organization for which it holds title, (*b*) the information necessary to establish the exemption, under section 101, of the organization for which title is held.

The collector, upon receipt of the affidavit and other papers, will forward them to the Commissioner for decision as to whether the organization is exempt.

When an organization has established its right to exemption, it need not thereafter make a return of income or any further showing with respect to its status under the law, unless it changes the character of its organization or operations or the purpose for which it was originally created. But see article 101 (18)-1 with respect to religious or apostolic associations or corporations. Collectors will keep a list of all exempt corporations, to the end that they may occasionally inquire into their status and ascertain whether or not they are observing the conditions upon which their exemption is predicated.

The exemption under section 101 referred to in this article and articles 101 (2)-1 to 101 (13)-1 from filing returns of income does not apply to returns of information (see sections 147 to 149).

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(1) Labor, agricultural, or horticultural organizations;

ART. 101 (1)-1. *Labor, agricultural, and horticultural organizations.*—The organizations contemplated by section 101 (1) as entitled to exemption from income taxation are those which—

(1) Have no net income inuring to the benefit of any member;

(2) Are educational or instructive in character; and

(3) Have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

Organizations such as county fairs and like associations of a quasi public character, which are designed to encourage the development of better agricultural and horticultural products through a system of awards, and whose income from gate receipts, entry fees, and donations is used exclusively to meet the necessary expenses of upkeep and operation, are thus exempt. On the other hand, associations which have for their purpose, for example, the holding of periodical race meets, the profits from which may inure to the benefit of their shareholders, are not exempt. Similarly, corporations engaged in growing agricultural or horticultural products for profit are not exempt from tax.

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(2) Mutual savings banks not having a capital stock represented by shares;

ART. 101 (2)-1. *Mutual savings banks.*—In order that a corporation may be entitled to exemption as a mutual savings bank, it must appear that it is an organization—

(1) Which has no capital stock represented by shares, and

(2) Whose earnings, less only the expenses of operation, are distributable wholly among the depositors.

If it appears that the organization has shareholders who participate in the profits, the organization will not be exempt.

A mutual savings bank need not be incorporated or be under public supervision, unless, in either case a State statute so requires, nor need it serve the public in general, in order to be exempt. It may confine its business to a designated class of individuals, such as employees of a single corporation, without losing its exempt status.

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(3) Fraternal beneficiary societies, orders, or associations, (A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (B) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

ART. 101 (3)-1. *Fraternal beneficiary society.*—A fraternal beneficiary society is exempt from tax only if operated under the "lodge system," or for the exclusive benefit of the members of a society so operating. "Operating under the lodge system" means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits.

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(4) Domestic building and loan associations substantially all the business of which is confined to making loans to members; and cooperative banks without capital stock organized and operated for mutual purposes and without profit;

ART. 101 (4)-1. *Building and loan associations and cooperative banks.*—A building and loan association organized pursuant to and operating in accordance with the laws of the United States or a State or Territory thereof, substantially all the business of which association is confined to making loans to members, is entitled to exemption.

Cooperative banks without capital stock organized and operated for mutual purposes and without profit are exempt. Credit unions such as those organized under the laws of Massachusetts, being in substance and in fact the same as cooperative banks, are likewise exempt from tax.

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(5) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual;

ART. 101 (5)-1. *Cemetery companies.*—A cemetery company may be entitled to exemption—

(1) If it is owned by and operated exclusively for the benefit of its lot owners who hold such lots for bona fide burial purposes and not for purpose of resale, or

(2) If it is not operated for profit.

Any cemetery corporation chartered solely for burial purposes and not permitted by its charter to engage in any business not necessarily incident to that purpose, is exempt from income tax, provided that no part of its net earnings inures to the benefit of any private shareholder or individual. A cemetery company which fulfills the other requirements of the Act may be exempt, even though it issues preferred stock entitling the holders to dividends at a fixed rate, not exceeding the legal rate of interest in the State of incorporation, or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, provided that its articles of incorporation require—

(1) That the preferred stock shall be retired at par as soon as sufficient funds available therefor are realized from sales, and

(2) That all funds not required for the payment of dividends upon or for the retirement of preferred stock shall be used by the company for the care and improvement of the cemetery property.

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

ART. 101(6)-1. *Religious, charitable, scientific, literary, and educational organizations and community chests.*—In order to be exempt under section 101 (6), the organization must meet three tests:

(1) It must be organized and operated exclusively for one or more of the specified purposes;

(2) Its net income must not inure in whole or in part to the benefit of private shareholders or individuals; and

(3) It must not by any substantial part of its activities attempt to influence legislation by propaganda or otherwise.

Corporations organized and operated exclusively for charitable purposes comprise, in general, organizations for the relief of the poor. The fact that a corporation established for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily deprive it of exemption.

An educational organization within the meaning of the Act is one designed primarily for the improvement or development of the capabilities of the individual, but, under exceptional circumstances, may include an association whose sole purpose is the instruction of the public, or an association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community, even though an association of either class has incidental amusement features. An organization formed, or availed of, to disseminate controversial or partisan propaganda is not an educational organization within the meaning of the Act. However, the publication of books or the giving of lectures advocating a cause of a controversial nature shall not of itself be sufficient to deny an organization the exemption, if carrying on propaganda, or otherwise attempting, to influence legislation form no substantial part of its activities, its principal purpose and substantially all of its activities being clearly of a nonpartisan, noncontroversial, and educational nature.

Since a corporation to be exempt under section 101 (6) must be organized and operated exclusively for one or more of the specified purposes, an organization which has certain religious purposes and which also manufactures and sells articles to the public for profit, is not exempt under section 101 (6) even though its property is held in common and its profits do not inure to the benefit of individual members of the organization. See section 101 (18) as to religious or apostolic associations or corporations.

A corporation otherwise exempt under section 101 (6) does not lose its status as an exempt corporation by receiving income such as rent, dividends and interest from investments, provided such income is devoted exclusively to one or more of the purposes specified in that section.

Money contributed by members of an organization to a common fund to be applied to the relief of the particular members of the organization or their families when in sickness, unemployed, in want, or under other disability, is not a charitable fund.

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(7) Business leagues, chambers of commerce, real-estate boards, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual;

ART. 101 (7)-1. *Business leagues, chambers of commerce, real estate boards, and boards of trade.*—A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not a business league, since its activities do not further any common business interest, even though all of its income is devoted to the purpose stated. A stock exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of the law and is not exempt from tax.

[SEC. 101. *Exemptions from tax on corporations.*]

[*The following organizations shall be exempt from taxation under this title*—]

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes;

ART. 101. (8)–1. *Civic leagues and local associations of employees.*—Civic leagues entitled to exemption under section 101 (8) comprise those not organized for profit but operated exclusively for purposes beneficial to the community as a whole, and, in general, include organizations engaged in promoting the welfare of mankind, other than organizations comprehended within section 101 (6). Certain local associations of employees are also expressly entitled to exemption under section 101 (8). The Act prescribes as conditions to exemption (1) that the membership of such an association be limited to the employees of a designated person or persons in a particular municipality, and (2) that the net earnings of the association be devoted exclusively to charitable, educational, or recreational purposes. See article 101 (6)–1 with reference to the meaning of "charitable" and "educational" and article 101 (10)–1 as to the meaning of "local" as used in the Act.

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder;

ART. 101 (9)–1. *Social clubs.*—The exemption granted by section 101 (9) applies to practically all social and recreation clubs which are supported by membership fees, dues, and assessments. If a club engages in traffic, in agriculture or horticulture, or in the sale of real estate, timber, etc., for profit, such club is not organized and operated exclusively for pleasure, recreation, or social purposes. Generally, an incidental sale of property will not deprive the club of the exemption.

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(10) Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 per centum or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses;

ART. 101 (10)–1. *Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.*—It is a prerequisite to exemption under section 101 (10) that at least 85 percent of the income of the organization shall consist of amounts collected from members for the sole purpose of meeting losses and expenses. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15 percent of its income is derived, it is not entitled to exemption. On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

The phrase "of a purely local character" applies to benevolent life insurance associations, and not to the other organizations specified in section 101 (10). It applies, however, to any organization seeking exemption on the ground that it is an organization similar to a benevolent life insurance association. An organization of a purely local character is one whose business activities are confined to a particular community, place, or district, irrespective, however, of political subdivisions. If the activities of an organization are limited only by the borders of a State it cannot be considered to be purely local in character.

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(11) Farmers' or other mutual hail, cyclone, casualty, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) the income of which is used or held for the purpose of paying losses or expenses;

ART. 101 (11)–1. *Farmers' or other mutual hail, cyclone, casualty, or fire insurance companies or associations.*—To be exempt under section 101 (11) the business of the organization must be purely mutual and its income must be used or held solely for the purpose of paying losses or expenses. Neither the extent of the territory in which the company may properly operate nor the fact that it accepts premium deposits instead of assessments is decisive as to its exemption. The writing of nonmutual insurance regardless of amount will deprive a company of the exemption.

The term "casualty" as used in section 101 (11) is limited to those forms of indemnity insurance providing for payment of loss or damage to property or personal injury to third persons resulting from accident or some such unanticipated contingency other than fire or the elements, and does not include indemnity from loss through accident resulting in bodily injury to, or death of, the insured.

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(12) Farmers', fruit growers', or like associations organized and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (b) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses. Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 per centum per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association; nor shall exemption be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose. Such an association may market the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, and may purchase supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 per centum of the value of all its purchases. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this paragraph;

ART. 101 (12)–1. *Farmers' cooperative marketing and purchasing associations.*—(*a*) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, live-stock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses, on the basis of the products furnished by them, are exempt from income tax and shall not be required to file returns. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of the quantity of milk or of butter fat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Act and is not exempt. In other words, nonmember patrons must be treated the same as members in so far as the distribution of patronage dividends is concerned, that is, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Act that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Act does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While under the Act patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association, instead of paying patronage dividends to nonmember producers in cash, keeps permanent records from which the proportionate shares of the patronage dividends due to nonmember producers can be determined, and such shares are made applicable toward the purchase price of a share of stock or of a membership in the association.

An association which has capital stock will not for such reason be denied exemption, (1) if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and (2) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends. The accumulation and maintenance of a reserve required by State statute, or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption. An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for nonmembers does not exceed the value of the products marketed for members. Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of section 101 (12).

(*b*) Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, livestock growers, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. The term "supplies and equipment" as used in section 101 (12) includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household. The provisions of (*a*) relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph. An association which purchases supplies and equipment for nonmembers will not for such reason be denied exemption, provided the value of the purchases for nonmembers does not exceed the value of the supplies and equipment purchased for members, and provided the value of the purchases made for nonmembers who are not producers does not exceed 15 percent of the value of all its purchases.

(*c*) In order to be exempt under either (*a*) or (*b*) an association must establish that it has no net income for its own account other than that reflected in a reserve or surplus authorized in (*a*). An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Act. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under section 101 (12) and this article. An association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 101 (12).

(*d*) Cooperative organizations engaged in occupations dissimilar from those of farmers, fruit growers, and the like, such as marketing building materials, are not exempt.

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(13) Corporations organized by an association exempt under the provisions of paragraph (12), or members thereof, for the purpose of financing the ordinary crop operations of such members or other producers, and operated in conjunction with such association. Exemption shall not be denied any such corporation because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 per centum per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the corporation, upon dissolution or otherwise, beyond the fixed dividends) is owned by such association, or members thereof; nor shall exemption be denied any such corporation because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose;

ART. 101 (13)-1. *Corporations organized to finance crop operations.*—Corporations organized by farmers' cooperative marketing or purchasing associations, or the members thereof, for the purpose of financing the ordinary crop operations of such members or other producers are also exempt, provided the marketing or purchasing association is exempt under section 101 (12), and the financing corporation is operated in conjunction with the marketing or purchasing association. The provisions of article 101 (12)-1 relating to a reserve or surplus and to capital stock shall also apply to corporations coming under this article.

[SEC. 101. *Exemptions from tax on corporations.*]

[The following organizations shall be exempt from taxation under this title—]

(14) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;

(15) Corporations organized under Act of Congress, if such corporations are instrumentalities of the United States and if, under such Act, as amended and supplemented, such corporations are exempt from Federal income taxes;

(16) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents, if (A) no part of their net earnings inures (other than through such payments) to the benefit of any private shareholder or individual, and (B) 85 per centum or more of the income consists of amounts collected from members for the sole purpose of making such payments and meeting expenses;

(17) Teachers' retirement fund associations of a purely local character, if (A) no part of their net earnings inures (other than through payment of retirement benefits) to the benefit of any private shareholder or individual, and (B) the income consists solely of amounts received from public taxation, amounts received from assessments upon the teaching salaries of members, and income in respect of investments;

(18) Religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or

corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro-rata shares, whether distributed or not, of the net income of the association or corporation for such year. Any amount so included in the gross income of a member shall be treated as a dividend received.

ART. 101 (18)-1. *Religious or apostolic associations or corporations.*—Religious or apostolic associations or corporations are exempt from taxation under Title I if they have a common treasury or community treasury, even though they engage in business for the common benefit of the members, provided each of the members includes (at the time of filing his return) in his gross income his entire pro rata share, whether distributed or not, of the net income of the association or corporation for the taxable year of the association or corporation ending with or during his taxable year. Any amount so included in the gross income of a member shall be treated as a dividend received.

Every association or corporation claiming exemption as a religious or apostolic association or corporation under the provisions of section 101 (18) and this article shall make for each taxable year a return stating specifically the items of its gross income and deductions, and its net income, and there shall be attached to the return as a part thereof a statement showing the name and address of each member of the association or corporation and the amount of his distributive share of the net income of the association or corporation for such year. If the taxable year of any member is different from the taxable year of the association or corporation, the distributive share of the net income of the association or corporation to be included in the gross income of the member for his taxable year shall be based upon the net income of the association or corporation for the taxable year of the association or corporation ending within the taxable year of the member.

CHAPTER XI

Corporations Used to Avoid Surtax

SEC. 102. *Surtax on corporations improperly accumulating surplus.*—(a) *Imposition of tax.*—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this title) upon the net income of every corporation (other than a personal holding company as defined in Title IA or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

25 per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

35 per centum of the undistributed section 102 net income in excess of $100,000.

(b) *Prima facie evidence.*—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of a purpose to avoid surtax upon shareholders.

(c) *Evidence determinative of purpose.*—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

(d) *Definitions.*—As used in this title—

(1) *Section 102 net income.*—The term "section 102 net income" means the net income minus the sum of—

(A) *Taxes.*—Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

(B) *Disallowed charitable, etc., contributions.*—Contributions or gifts payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o), for the purposes therein specified.

(C) *Disallowed losses.*—Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(2) *Undistributed section 102 net income.*—The term "undistributed section 102 net income" means the section 102 net income minus the basic surtax credit provided in section 27 (b), but the computation of such credit under section 27 (b) (1) shall be made without its reduction by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(e) *Tax on personal holding companies.*—For surtax on personal holding companies, see Title IA.

ART. 102-1. *Taxation of corporation formed or utilized for avoidance of surtax.*—Section 102 imposes (in addition to other taxes imposed by Title I) a graduated income tax or surtax upon any domestic or foreign corporation formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of dividing or distributing them. However, personal holding companies, as defined in Title IA, and foreign personal holding companies, as defined in Supplement P, are excepted from taxation under section 102. The surtax imposed by section 102 applies whether the avoidance was accomplished through the formation or use of only one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation so that the dividend distributions of the M Corporation would not be returned as income subject to the individual surtax until distributed in turn by the N Corporation to its individual shareholders, nevertheless the surtax imposed by section 102 applies to the M Corporation, if that corporation is formed or availed of for the purpose of preventing the imposition of the individual surtax upon the individual shareholders of the N Corporation.

A foreign corporation, whether resident or nonresident, formed or availed of for the purpose specified in section 102 is subject to the tax imposed thereby if it derives income from sources within the United States as defined in section 119 and the regulations thereunder, if any of its shareholders are (1) citizens or residents of the United States and therefore subject to the surtax with respect to distributions of the corporation or (2) nonresident alien individuals who, by the application of section 211 (b) or section 211 (c), would be subject to the surtax with respect to distributions of the corporation which if made would constitute income from sources within the United States (see section 119) or (3) foreign corporations if any beneficial interest therein is owned directly or indirectly by any shareholder specified in (1) or (2). On the other hand, the tax imposed by section 102 will not apply even though a foreign corporation, whether resident or nonresident, derives income from sources within the United States, if all of its shareholders are nonresident alien individuals who, by the application of section 211 (a) as amended, would not be subject to surtax with respect to distributions of the corporation if made.

For the computation of the surtax see article 102-4.

ART. 102-2. *Purpose to avoid surtax; evidence; burden of proof; definition of holding or investment company.*—The Commissioner's determination that a corporation was formed or availed of for the purpose of avoiding the individual surtax is subject to disproof by competent evidence. The existence or nonexistence of the purpose may be indicated by circumstances other than the evidence specified in the Act, and whether or not such purpose was present depends upon the particular circumstances of each case. In other words, a corporation is subject to taxation under section 102 if it is formed or availed of for the *purpose* of preventing the imposition of surtax upon shareholders through the medium of permitting earnings or profits to accumulate, even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits; and on the other hand, the fact that a corporation is such a company or has such an accumulation is not absolutely conclusive against it if, by clear and convincing evidence, the taxpayer satisfies the Commissioner that the corporation was neither formed or availed of for the purpose of avoiding the individual surtax. All the other circumstances which might be construed as evidence of the purpose to avoid surtax cannot be outlined, but among other things the following will be considered: (1) Dealings between the corporation and its shareholders, such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders, and (2) the investment by the corporation of undistributed earnings in assets having no reasonable connection with the business. The mere fact that the corporation distributed a large portion of its earnings for the year in question does not necessarily prove that earnings were not permitted to accumulate beyond reasonable needs or that the corporation was not formed or availed of to avoid surtax upon shareholders.

If the Commissioner determines that the corporation was formed or availed of for the purpose of avoiding the individual surtax through the medium of permitting earnings or profits to accumulate, and the taxpayer contests such determination of fact by litigation, the burden of proving the determination wrong by a preponderance of evidence, together with the corresponding burden of first going forward with evidence, is on the taxpayer under principles applicable to income tax cases generally, and this is so even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits. However, if the corporation *is* a mere holding or investment company, then the Avt gives further weight to the presumption of correctness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid surtax upon shareholders, while if earnings or profits are permitted to accumulate beyond the reasonable needs of the business, then the Act adds still more weight to the Commissioner's determination by providing that irrespective of whether or not the corporation is a mere holding or investment company, the existence of such an accumulation is *determinative* of the purpose to avoid surtax upon shareholders unless the taxpayer proves the contrary by such a clear preponderance of all the evidence that the absence of such a purpose is unmistakable.

A corporation having practically no activities except holding property, and collecting the income therefrom or investing therein, shall be considered a holding company within the meaning of section 102. If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or a marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 102.

ART. 102-3. *Unreasonable accumulations of profits.*—An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent accumulations of surplus for the reasonable needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of earnings or profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax. If one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance although not in legal form the business of the first corporation. Earnings or profits of the first corporation put into the second through the purchase of stock or otherwise may, therefore, if a subsidiary relationship is established, constitute employment of the income of its own business. Investment by a corporation of its income in stock and securities of another corporation is not of itself to be regarded as employment of the income in its business. The business of one corporation may not be regarded as including the business of another unless the other corporation is a mere instrumentality of the first; to establish this it is ordinarily essential that the first corporation own all or substantially all of the stock of the second.

The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated earnings and profits, the name and address of, and number of shares held by each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 148 (c).)

ART. 102-4. *Computation of undistributed section 102 net income.*—In ascertaining the tax basis for corporations subject to the provisions of section 102, the "section 102 net income" is first computed. This is accomplished in the case of a domestic corporation by subtracting from the corporate net income, as defined in sections 21 and 204, (*a*) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23 (c), but not including the graduated income tax or surtax imposed by section 102 or corresponding sections of prior Revenue Acts; (*b*) contributions or gifts payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o), for the purposes therein specified; (*c*) losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d). In the case of a foreign corporation, whether resident or nonresident, which files or causes to be filed a return the "section 102 net income" means the net income from sources within the United States (gross income from sources within the United States, as defined in section 119 and the regulations thereunder, less statutory deductions) minus the amount of the deductions enumerated in (*a*), (*b*), and (*c*) above. In the case of a foreign corporation, whether resident or nonresident, which files no return the "section 102 net income" means the gross income from sources within the United States, as defined in section 119, and the regulations thereunder, without the benefit of the deductions enumerated in (*a*), (*b*), and (*c*) above, or any other deductions. (See section 233.)

The "section 102 net income" includes interest upon obligations of the United States and obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States, except as provided in section 22 (b) (4). The "section 102 net income" does not include interest on obligations of States or Territories of the United States or any political subdivision thereof or of the District of Columbia or of the possessions of the United States.

The "undistributed section 102 net income" is computed by subtracting from the "section 102 net income" described above, the amount of the basic surtax credit provided in section 27 (b). In computing the basic surtax credit for the purpose of section 102, the credit under section 27 (b) (1) is not to be reduced by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

CHAPTER XII

Tax on Citizens and Corporations of Foreign Countries—Banks and Trust Companies—Sale of Oil or Gas Properties

SEC. 103. *Rates of tax on citizens and corporations of certain foreign countries.*—Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 11, 12, 13, 14, 201 (b), 204 (a), 207, 211 (a), 231 (a), and 362 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country; but the tax at such doubled rate shall be considered as imposed by section 11, 12, 13, 14, 201 (b), 204 (a), 207, 211 (a), 231 (a), or 362, as the case may be. In no case shall this section operate to increase the taxes imposed by such sections (computed without regard to this section) to an amount in excess of 80 per centum of the net income of the taxpayer. Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under the preceding provisions of this section have been modified so that discriminatory and extraterritorial taxes applicable to citizens and corporations of the United States have been removed, he shall so proclaim, and the provisions of this section providing for doubled rates of tax shall not apply to any citizen or corporation of such foreign country with respect to any taxable year beginning after such proclamation is made.

SEC. 104. *Banks and trust companies.*—(a) *Definition.*—As used in this section the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11 (k) of the Federal Reserve Act, as amended, and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions.

(b) *Rate of tax.*—Banks shall be taxable under section 14 (d).

SEC. 105. *Sale of oil or gas properties.*—In the case of a bona fide sale of any oil or gas property, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the taxpayer, the portion of the tax imposed by section 12 attributable to such sale shall not exceed 30 per centum of the selling price of such property or interest.

ART. 105-1. *Surtax on sale of oil or gas properties.*—If the taxpayer by prospecting and locating claims, or by exploring or discovering undeveloped claims, has demonstrated the principal value of oil or gas property, which prior to his efforts had a relatively minor value, the portion of the surtax imposed by section 12 attributable to a sale of such property or of the taxpayer's interest therein shall not exceed 30 percent of the selling price. Shares of stock in a corporation owning oil or gas property do not constitute an interest in such property. To determine the application of section 105 to a particular case, the taxpayer should first compute the surtax imposed by section 12 upon his entire surtax net income, including the net income from any sale of such property or interest therein, without regard to section 105. The proportion of the surtax, so computed, indicated by the ratio which the taxpayer's net income from the sale of the property or interest therein, computed as prescribed in this article, bears to his total net income is the portion of the surtax attributable to such sale, and if it exceeds 30 percent of the selling price of such property or interest, such portion of the surtax shall be reduced to that amount.

In determining the portion of the net income attributable to the sale of such oil or gas property or interest therein, the taxpayer shall allocate to the gross income derived from such sale, and to the gross income derived from all other sources, the expenses, losses, and other deductions properly appertaining thereto and shall apply any general expenses, losses, and deductions (which cannot properly be otherwise apportioned) ratably to the gross income from all sources. The gross income derived from the sale of such oil or gas property or interest therein, less the deductions properly appertaining thereto and less its proportion of any general deductions, shall be the net income attributable to such sale. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or apportioned.

SEC. 106. *Claims against United States involving acquisition of property.*—In the case of amounts (other than interest) received by a taxpayer from the United States with respect to a claim against the United States involving the acquisition of property and remaining unpaid for more than fifteen years, the portion of the tax imposed by section 12 attributable to such receipt shall not exceed 30 per centum of the amount (other than interest) so received.

ART. 106-1. *Surtax on certain amounts received from the United States.*—The method of computation provided for in article 105-1, relating to the limitation on surtax on the sale of oil or gas properties, shall be applicable in computing, under section 106, the surtax imposed by section 12 attributable to certain amounts received by the taxpayer from the United States under a claim involving acquisition of his property. The surtax limitation provided in section 106 is not applicable to any amount received from the United States which constitutes interest, whether such interest was included in the claim or in any judgment thereon or has accrued on such judgment.

CHAPTER XIII

Gain or Loss—Recognition, Basis, Determination

Supplement B—Computation of Net Income [Supplementary to Subtitle B, Part II]

SEC. 111. *Determination of amount of, and recognition of, gain or loss.*—(a) *Computation of gain or loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of gain or loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

(d) *Installment sales.*—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

ART. 111-1. *Computation of gain or loss.*—Except as otherwise provided, the Act regards as income or as loss sustained, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property which is received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 111, which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 113 (b) and articles 113 (b)-1 to 113 (b)-3 (i. e., the cost or other basis provided by section 113 (a), adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained in the amount of the insufficiency. The basis may be different depending upon whether gain or loss is being computed.

Even though property is not sold or otherwise disposed of, gain (includible in gross income under section 22 (a) as "gains or profits and income derived from any source whatever") is realized if the sum of all the amounts received which are required by section 113 (b) to be applied against the basis of the property exceeds such basis. On the other hand, a loss is not ordinarily sustained prior to the sale or other disposition of the property, for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof the Act takes no account of it. The provisions of this paragraph may be illustrated by the following example:

Example: A purchased certain shares of stock subsequent to February 28, 1913, for $10,000. On January 1, 1938, A's adjusted basis for the stock had been reduced to $1,000, by reason of receipts and distributions described in section 113 (b) (1) (A) and (D). He received in 1938 a further distribution of $5,000, being a distribution described in section 113 (b) (1) (D). This distribution applied against the adjusted basis as required by section 113 (b) (1) (D) exceeds that basis by $4,000. The amount of the excess, namely, $4,000, is a gain realized by A in 1938 includible, as a gain from the stock, in gross income in his return for that calendar year. In computing gain from the stock, as in adjusting basis, no distinction is made between items of receipts or distributions described in section 113 (b). If A sells the stock in 1939 for $5,000, he realizes in 1939 a gain of $5,000, since the adjusted basis of the stock for the purpose of computing gain or loss from the sale is zero.

In the case of property sold on the installment plan, special rules for the taxation of the gain are prescribed in section 44.

SEC. 112. *Recognition of gain or loss.*—(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

ART. 112 (a)-1. *Sales or exchanges.*—The extent to which the amount of gain or loss, determined under section 111, from the sale or exchange of property is to be recognized is governed by the provisions of section 112. The general rule is that the entire amount of such gain or loss is to be recognized.

An exception to the general rule is made by section 112 (b) (1) to (5), inclusive, in the case of certain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Act provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

The Act makes specific provision for the case in which, in addition to property which may be received tax free on the exchange, there is received as boot other property or money. In such a case gain is recognized to the extent of the boot (see section 112 (c) and (d)), but no loss of any kind is recognized (see section 112 (e)).

The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Act only if the exchange is one which satisfies both (1) the specific description in the Act of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

To constitute an exchange within the meaning of section 112 (b) (1) to (5), inclusive, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

See section 112 (b) (6) and (7) with respect to nonrecognition of gain or loss upon the receipt of property distributed in complete liquidation of a corporation under certain specifically described circumstances. See sections 112 (b) (8) and 371 with respect to nonrecognition of gain or loss upon exchanges and distributions made in obedience to orders of the Securities and Exchange Commission.

[SEC. 112. *Recognition of gain or loss.*]
(b) *Exchanges solely in kind.*—(1) *Property held for productive use or investment.*—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

ART. 112 (b) (1)-1. *Property held for productive use in trade or business or for investment.*—As used in section 112 (b) (1), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under this paragraph, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

Gain or loss is recognized if a taxpayer exchanges (1) Treasury bonds maturing October 15, 1945, for Treasury bonds maturing June 15, 1963, or (2) a real estate mortgage for bonds of the Home Owners' Loan Corporation.

[SEC. 112. *Recognition of gain or loss.*]
[(b) *Exchanges solely in kind.*—]
(2) *Stock for stock of same corporation.*—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

ART. 112 (b) (2)-1. *Stock for stock of the same corporation.*—The exchange, without the recognition of gain or loss, of common stock for common stock, or of preferred stock for preferred stock, in the same corporation is not limited to a transaction between a stockholder and the corporation; it includes an exchange between two individual stockholders. However, the provisions of section 112 (b) (2) do not apply if stock is exchanged for bonds, or preferred stock is exchanged for common stock, or common stock is exchanged for preferred stock, or common stock in one corporation is exchanged for common stock in another corporation.

[SEC. 112. *Recognition of gain or loss.*]
[(b) *Exchanges solely in kind.*—]
(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) *Same—Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

ART. 112 (b) (5)-1. *Transfer of property to corporation controlled by transferor.*—As used in section 112 (b) (5), the phrase "one or more persons" includes individuals, trusts or estates, partnerships and corporations (see section 901); and to be in "control" of the transferee corporation such person or persons must own immediately after the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation. (See section 112 (h).) The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

Example 1: A owns certain real estate which cost him $50,000 in 1920, but which has a fair market value of $150,000 in 1938. He transfers this property to the M Corporation, a newly formed company, for all the latter's capital stock. No gain or loss is recognized on the transaction.

Example 2: C owns a patent right worth $25,000 and D owns a manufacturing plant, worth $75,000. C and D organize the R Corporation with an authorized capital stock of $100,000. C transfers his patent right to the R Corporation for $25,000 of its stock and D transfers his plant to the new corporation for $75,000 of its stock. No gain or loss to C or D is recognized.

Example 3: B owns certain real estate which cost him $50,000 in 1920, but which has a fair market value of $200,000 in 1938. He transfers the property to the N Corporation in 1938 for 78 percent of each class of stock of the corporation, the remaining 22 percent of the stock of the corporation having been issued by the corporation in 1933 to other persons for cash. B realizes a taxable gain of $150,000 on this transaction. (See section 112 (h).)

ART. 112 (b) (5)-2. *Records to be kept and information to be filed.*—Every person who receives the stock or securities of a controlled corporation for property under section 112 (b) (5) shall file with his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

1. A description of the property transferred, or of his interest in such property, together with a statement of the cost or other basis thereof, adjusted to the date of the transfer, and

2. A statement of the amount of stock or securities and other property or money received in the exchange. The amount of each kind of stock or securities and other property received shall be set forth at its fair market value at the date of the exchange.

Every such controlled corporation shall file with its income tax return for the taxable year in which the exchange takes place:

(1) A full description of all property received from the transferors, together with a statement of the cost or other basis thereof in the hands of the transferors adjusted to the date of the transfer, and

(2) A statement of the amount of stock or securities and other property or money which passed to the transferors in the transaction, together with a full statement of the amount of the issued and outstanding stock and securities of such controlled corporation immediately after the exchange and of the ownership of each transferor of each class of stock of such controlled corporation immediately after the exchange (showing as to each class the number of shares and percentage owned and the voting power of each share).

Permanent records in substantial form shall be kept by every taxpayer who participates in a tax-free exchange under section 112 (b) (5) showing the cost or other basis in his hands of the transferred property, and of the amount of stock or securities and other property or money received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received in the exchange.

[SEC. 112. *Recognition of gain or loss.*]
[(b) *Exchanges solely in kind.*—]
(6) *Property received by corporation on complete liquidation of another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. For the purposes of this paragraph a distribution shall be considered to be in complete liquidation only if—

(A) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 per centum of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), and was at no time on or after the date of the adoption of the plan of liquidation and until the receipt of the property the owner of a greater percentage of any class of stock than the percentage of such class owned at the time of the receipt of the property; and

(B) no distribution under the liquidation was made before the first day of the first taxable year of the corporation beginning after December 31, 1935; and either

(C) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock, shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or

(D) such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within three years from the close of the taxable year during which is made the first of the series of distributions under the plan, except that if such transfer is not completed within such period, or if the taxpayer does not continue qualified under subparagraph (A) until the completion of such transfer, no distribution under the plan shall be considered a distribution in complete liquidation.

If such transfer of all the property does not occur within the taxable year the Commissioner may require of the taxpayer such bond, or waiver of the statute of limitations on assessment and collection, or both, as he may deem necessary to insure, if the transfer of the property is not completed within such three-year period, or if the taxpayer does not continue qualified under subparagraph (A) until the completion of such transfer, the assessment and collection of all income, war-profits, and excess-profits taxes then imposed by law for such taxable year or subsequent taxable years, to the extent attributable to property so received. A distribution otherwise constituting a distribution in complete liquidation within the meaning of this paragraph shall not be considered as not constituting such a distribution merely because it does not constitute a distribution or liquidation within the meaning of the corporate law under which the distribution is made; and for the purposes of this paragraph a transfer of property of such other corporation to the taxpayer shall not be considered as not constituting a distribution (or one of a series of distributions) in complete cancellation or redemption of all the stock of such other corporation, merely because the carrying out of the plan involves (i) the transfer under the plan to the taxpayer by such other corporation of property, not attributable to shares owned by the taxpayer, upon an exchange described in paragraph (4) of this subsection, and (ii) the complete cancellation or redemption under the plan, as a result of exchanges described in paragraph (3) of this subsection, of the shares not owned by the taxpayer.

ART. 112 (b) (6)-1. *Distributions in liquidation of subsidiary corporation.*—(*a*) *General.*—Under the general rule prescribed by section 115 (c) for the treatment of distributions in liquidation of a corporation, amounts received by one corporation in complete liquidation of another corporation are treated as in full payment in exchange for stock in such other corporation, and gain or loss from the receipt of such amounts is to be determined as provided in section 111. The scope of this treatment is governed by the meaning of the term "amounts distributed in complete liquidation of a corporation" as used in section 115 (c). Section 112 (b) (6) excepts from the general rule property received, under certain specifically described circumstances, by one corporation as a distribution in complete liquidation of another corporation and provides for the nonrecognition of gain or loss in those cases which meet the statutory requirements. Section 112 (i) places a limitation on the application of section 112 (b) (6) in the case of foreign corporations. See article 113 (a) (15)-1 for the basis for determining gain or loss from the subsequent sale of property received upon complete liquidations such as described in this article.

(*b*) *Requirements for nonrecognition of gain or loss.*—The nonrecognition of gain or loss is limited to the receipt of such property by a corporation which is the actual owner of stock (in the liquidating corporation) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends). The Act expressly requires that the recipient corporation must have been the owner of the specified amount of such stock on the date of the adoption of the plan of liquidation and have continued so to be at all times until the receipt of the property. The Act also expressly requires that the recipient corporation shall at no time on or after the date of the adoption of the plan and until the receipt of the property, be the owner of a greater percentage of any class of stock than the percentage of such class owned at the time of the receipt of the property. If the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation and if the failure to continue qualified occurs at any time prior to the completion of the transfer of all the property, the provisions for the nonrecognition of gain or loss do not apply to any distribution received under the plan.

The provisions of section 112 (b) (6) do not apply to any liquidation if any distribution in pursuance thereof has been made before the first day of the first taxable year of the recipient corporation beginning after December 31, 1935.

To constitute a distribution in complete liquidation within the meaning of section 112 (b) (6), the distribution must be (*a*) made by the liquidating corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation or (*b*) one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation. It is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue to the date of dissolution of the corporation. A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts and distributing any remaining balance to its shareholders. A liquidation may be completed prior to the actual dissolution of the liquidating corporation but no liquidation is completed until the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible). (See article 22 (a)-21.)

If a transaction constitutes a distribution in complete liquidation within the meaning of the Act and satisfies the requirements of section 112 (b) (6), it is not material that it is otherwise described under the local law. If a liquidating corporation distributes all of its property in complete liquidation and if pursuant to the plan for such complete liquidation a corporation owning the specified amount of stock in the liquidating corporation receives property constituting amounts distributed in complete liquidation within the meaning of the Act and also receives other property attributable to shares not owned by it, the transfer of the property to the recipient corporation shall not be treated, by reason of the receipt of such other property, as not being a distribution (or one of a series of distributions) in complete cancellation or redemption of all of the stock of the liquidating corporation within the meaning of section 112 (b) (6), even though for purposes of those provisions in section 112 relating to reorganizations the amount received by the recipient corporation in excess of its ratable share is regarded as acquired upon the issuance of its stock or securities in a tax-free exchange as described in section 112 (b) (4) and the cancellation or redemption of the stock not owned by the recipient corporation is treated as occurring as a result of a tax-free exchange described in section 112 (b) (3). The application of this paragraph may be illustrated by the following example:

Example: On July 1, 1938, the M Corporation had outstanding capital stock consisting of 3,000 shares of common stock, par value $100 a share, and 1,000 shares of preferred stock, par value $100 a share, which preferred stock was limited and preferred as to dividends and had no voting rights. On July 1, 1938, and thereafter until the date of dissolution of the M Corporation, the O Corporation owned 2,500 shares of the common stock of the M Corporation. By a statutory merger consummated on August 1, 1938, pursuant to a plan of liquidation adopted on July 1, 1938, the M Corporation was merged into the O Corporation, the O Corporation under the plan issuing stock which was received by the holders of the stock of the M Corporation not owned by the O Corporation in exchange for their stock in the M Corporation. The receipt by the O Corporation of the properties of the M Corporation is a distribution received by the O Corporation in complete liquidation of the M Corporation within the meaning of section 112 (b) (6), and no gain or loss is recognized as the result of the receipt of such properties.

ART. 112 (b) (6)-2. *Liquidations completed within one taxable year.*—If in a liquidation completed within one taxable year, pursuant to a plan of complete liquidation, distributions in complete liquidation are received by a corporation which owns the specified amount of stock in the liquidating corporation and which continues qualified with respect to the ownership of such stock until the transfer of all the property within such year is completed (see article 112 (b) (6)-1), then no gain or loss shall be recognized with respect to the distributions received by the recipient corporation. In such case no waiver or bond is required of the recipient corporation under section 112 (b) (6).

ART. 112 (b) (6)-3. *Liquidations covering more than one taxable year.*—If the plan of liquidation is consummated by a series of distributions covering a period of more than one taxable year, the nonrecognition of gain or loss with respect to the distributions in liquidation shall in addition to the requirements of article 112 (b) (6)-1, be subject to the following requirements:

(*a*) In order for the distribution in liquidation to be brought within the exception provided in section 112 (b) (6) to the general rule for computing gain or loss with respect to amounts received in liquidation of a corporation, the entire property of the corporation shall be transferred in accordance with a plan of liquidation, which plan shall include a statement showing the period within which the transfer of the property of the liquidating corporation to the recipient corporation is to be completed. The transfer of all the property under the liquidation must be completed within three years from the close of the taxable year during which is made the first of the series of distributions under the plan.

(*b*) For each of the taxable years which falls wholly or partly within the period of liquidation, the recipient corporation shall, at the time of filing its return, file with the collector for transmittal to the Commissioner a waiver of the statute of limitations on assessment. The waiver shall be executed on such form as may be prescribed by the Commissioner and shall extend the period for assessment of all income and profits taxes for each such year to a date not earlier than one year after the last date of the period for assessment of such taxes for the last taxable year in which the transfer of the property of the liquidating corporation to the controlling corporation may be completed in accordance with section 112 (b) (6). Such waiver shall also contain such other terms with respect to assessment as may be considered by the Commissioner to be necessary to insure the assessment and collection of the correct tax liability for each year within the period of liquidation.

(*c*) For each of the taxable years which falls wholly or partly within the period of liquidation, the recipient corporation shall file a bond, the amount of which shall be fixed by the Commissioner. The bond shall contain all terms specified by the Commissioner, including provisions unequivocally assuring prompt payment of the excess of income and profits taxes (plus penalty, if any, and interest) as computed by the Commissioner without regard to the provisions of sections 112 (b) (6) and 113 (a) (15) over such taxes computed with regard to such provisions, regardless of whether such excess may or may not be made the subject of a notice of deficiency under section 272 and regardless of whether it may or may not be assessed. Any bond required under section 112 (b) (6) shall have such surety or sureties as the Commissioner may require. However, see section 1126 of the Revenue Act of 1926, as amended (paragraph 35 of the Appendix to these regulations), providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. Only surety companies holding certificates of authority from the Secretary as acceptable sureties on Federal bonds will be approved as sureties. The bonds shall be executed in triplicate so that the Commissioner, the taxpayer, and the surety or the depositary may each have a copy.

Pending the completion of the liquidation, if there is a compliance with paragraphs (*a*), (*b*), and (*c*) of this article and article 112 (b) (6)-1 with respect to the nonrecognition of gain or loss, the income and profits tax liability of the recipient corporation for each of the years covered in whole or in part by the liquidation shall be determined without the recognition of any gain or loss on account of the receipt of the distributions in liquidation. In such determination, the basis of the property or properties received by the recipient corporation shall be determined in accordance with section 113 (a) (15). (See article 113 (a) (15)-1.) However, if the transfer of the property is not completed within the 3-year period allowed by section 112 (b) (6) or if the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation as required by that section, gain or loss shall be recognized with respect to each distribution and the tax liability for each of the years covered in whole or in part by the liquidation shall be recomputed without regard to the provisions of section 112 (b) (6) or section 113 (a) (15) and the amount of any additional tax due upon such recomputation shall be promptly paid.

ART. 112 (b) (6)-4. *Distributions in liquidation as affecting minority interests.*—Upon the liquidation of a corporation in pursuance of a plan of complete liquidation, the gain or loss of minority shareholders shall be determined without regard to section 112 (b) (6), since it does not apply to that part of distributions in liquidations received by minority shareholders.

ART. 112 (b) (6)-5. *Records to be kept and information to be filed with return.*—(*a*) Permanent records in substantial form shall be kept by every corporation receiving distributions in complete liquidation within the exception provided in section 112 (b) (6) showing the information required by this article to be submitted with its return. The plan of liquidation must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of each such corporation.

(*b*) For the taxable year in which the liquidation occurs, or, if the plan of liquidation provides for a series of distributions over a period of more than one year, for each taxable year in which a distribution is received under the plan, the recipient shall file with its return a complete statement of all facts pertinent to the nonrecognition of gain or loss, including—

(1) A certified copy of the plan for complete liquidation, and of the resolutions under which the plan was adopted and the liquidation was authorized, together with a statement under oath showing in detail all transactions incident to, or pursuant to, the plan.

(2) A list of all the properties received upon the distribution, showing the cost or other basis of such properties to the liquidating corporation at the date of distribution and the fair market value of such properties on the date distributed.

(3) A statement as to its ownership of all classes of stock of the liquidating corporation (showing as to each class the number of shares and percentage owned and the voting power of each share) as of the date of the adoption of the plan of liquidation, and at all times since, to and including the date of the distribution in liquidation, and the cost or other basis of such stock.

[SEC. 112. *Recognition of gain or loss.*]
[(*b*) *Exchanges solely in kind.*—]
(7) *Election as to recognition of gain in certain corporate liquidations.*—(A) *General rule.*—In the case of property distributed in complete liquidation of a domestic corporation, if—

(i) the liquidation is made in pursuance of a plan of liquidation adopted after the date of the enactment of this Act, whether the taxable year of the corporation began on, before, or after January 1, 1938; and
(ii) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within the month of December, 1938—

then in the case of each qualified electing shareholder (as defined in subparagraph (C)) gain upon the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subparagraph (E) and (F).
(B) *Excluded corporation.*—The term "excluded corporation" means a corporation which at any time between April 9, 1938, and the date of the adoption of the plan of liquidation, both dates inclusive, was the owner of stock possessing 50 per centum or more of the total combined voting power of all classes of stock entitled to vote on the adoption of such plan.
(C) *Qualified electing shareholders.*—The term "qualified electing shareholder" means a shareholder (other than an excluded corporation) of any class of stock (whether or not entitled to vote on the adoption of the plan of liquidation) who is a shareholder at the time of the adoption of such plan, and whose written election to have the benefits of subparagraph (A) has been made and filed in accordance with subparagraph (D), but—

(i) in the case of a shareholder other than a corporation, only if written elections have been so filed by shareholders (other than corporations) who at the time of the adoption of the plan of liquidation are owners of stock possessing at least 80 per centum of the total combined voting power (exclusive of voting power possessed by stock owned by corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation; or
(ii) in the case of a shareholder which is a corporation, only if written elections have been so filed by corporate shareholders (other than an excluded corporation) which at the time of the adoption of such plan of liquidation are owners of stock possessing at least 80 per centum of the total combined voting power (exclusive of voting power possessed by stock owned by an excluded corporation and by shareholders who are not corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation.

(D) *Making and filing of elections.*—The written elections referred to in subparagraph (C) must be made and filed in such manner as to be not in contravention of regulations prescribed by the Commissioner with the approval of the Secretary. The filing must be within thirty days after the adoption of the plan of liquidation, and may be by the liquidating corporation or by the shareholder.

(E) *Noncorporate shareholders.*—In the case of a qualified electing shareholder other than a corporation—

(i) There shall be recognized, and taxed as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of December 31, 1938, but without diminution by reason of distributions made during the month of December, 1938; and
(ii) There shall be recognized, and taxed as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after April 9, 1938, exceeds his ratable share of such earnings and profits.

(F) *Corporate shareholders.*—In the case of a qualified electing shareholder which is a corporation the gain shall be recognized only to the extent of the greater of the two following—

(i) The portion of the assets received by it which consists of money, or of stock or securities acquired by the liquidating corporation after April 9, 1938; or
(ii) Its ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, such earnings and profits to be determined as of December 31, 1938, but without diminution by reason of distributions made during the month of December, 1938.

ART. 112 (b) (7)-1. *Corporate liquidations in December, 1938.*—(*a*) *General.*—Section 112 (b) (7) provides a special rule, in the case of certain specifically described complete liquidations of domestic corporations occurring within the month of December, 1938, for the treatment of gain on the shares of stock owned by qualified electing shareholders on the date of the adoption of the plan of liquidation. The effect of such section is in general to postpone the recognition of that portion of a qualified electing shareholder's gain on the liquidation which would otherwise be recognized and which is attributable to appreciation in the value of certain corporate assets unrealized by the corporation at the time such assets are distributed in complete liquidation. Only qualified electing shareholders are entitled to the benefits of section 112 (b) (7). The determination of who is a qualified electing shareholder is to be made under section 112 (b) (7) (C) and article 112 (b) (7)-2. For the basis of property received on such liquidations, see section 113 (a) (18).

(b) *Type of liquidation.*—The liquidation must be in pursuance of a plan of liquidation adopted after May 28, 1938. Such plan may be adopted at any time after May 28, 1938, and before the first distribution under the liquidation occurs, even though the date of adoption falls in a taxable year of the liquidating corporation to which the Revenue Act of 1936 applies. The Act specifically requires that the distribution be in complete cancellation or redemption of all the stock of the corporation. The Act also requires that the transfer of all the property, both tangible and intangible, of the corporation under the liquidation occur entirely within the month of December, 1938, but if proper arrangements are made in good faith for the payment, after December 31, 1938, of unascertained or contingent liabilities and expenses, this requirement will be considered to have been complied with. The assets reserved for this purpose must be in cash and must be reasonable in amount. Though it is not necessary that the corporation dissolve in December, 1938, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue to the date of dissolution of the corporation. A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders.

If a transaction constitutes a distribution in complete liquidation within the meaning of the Act and satisfies the requirements of section 112 (b) (7), it is immaterial that it is otherwise described under the local law.

ART. 112 (b) (7)-2. *Qualified electing shareholder.*—No corporate shareholder may be a qualified electing shareholder if at any time between April 9, 1938, and the date of the adoption of the plan of liquidation, both dates inclusive, it is the owner of stock of the liquidating corporation possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote upon the adoption of the plan of liquidation. All other shareholders are divided into two groups for the purposes of determining whether they are qualified electing shareholders: (a) shareholders other than corporations, and (b) corporate shareholders. Any shareholder of either of such two groups (whether or not the stock he owns is entitled to vote on the adoption of the plan of liquidation) is a qualified electing shareholder if—

(1) His written election to be governed by the provisions of section 112 (b) (7) (which cannot be withdrawn or revoked) has been made and filed as prescribed in article 112 (b) (7)-3; and

(2) Like elections have been made and filed by owners of stock possessing at least 80 percent of the total combined voting power of all classes of stock owned by shareholders of the same group on the date of, and entitled to vote upon, the adoption of the plan of liquidation, whether or not the shareholders making such elections actually realize gain upon the cancellation or redemption of such stock upon the liquidation.

Example: The R Corporation has outstanding 20 shares of common stock on July 1, 1938, the date of the adoption of a plan of liquidation within the provisions of section 112 (b) (7), each entitled to one vote upon the adoption of such plan of liquidation. Ten of such shares are owned by the S Corporation, two each by the X Corporation and the Y Corporation, one by the Z Corporation, and one each by A, B, C, D, and E, individuals. There are also outstanding two shares of preferred stock, not entitled to vote on liquidation, one share being owned by F, an individual, and one share by the P Corporation. The S Corporation, being a corporate shareholder and the owner of 50 percent of the voting stock, may not be a qualified electing shareholder under any circumstances. In order for any other corporate shareholder to be a qualified electing shareholder, it is necessary that the X Corporation and the Y Corporation file their written elections to be governed by section 112 (b) (7). If this is done, the P Corporation will also be a qualified electing shareholder if it has filed a like election. Similarly, in the case of the individual shareholders, some combination of four of the individual holders of the common stock must have filed their written elections, before any individual shareholder may be considered a qualified electing shareholder, but if this is done, F will also be a qualified electing shareholder if he has filed a like election.

An election to be governed by the provisions of section 112 (b) (7) relates to the treatment of gain realized upon the cancellation or redemption of stock upon liquidation and can therefore be made only by or on behalf of the person by whom gains, if any, will be realized. Thus, the shareholder who may make such election must be the actual owner of the stock and not a mere record holder, such as a nominee.

A shareholder is entitled to make an election relative to the gain only on stock owned by him at the time of the adoption of the plan of liquidation. The election is personal to the shareholder making it and does not follow such stock into the hands of a transferee.

ART. 112 (b) (7)-3. *Making and filing of written elections.*—An election to be governed by section 112 (b) (7) shall be made in duplicate under oath or affirmation on Form 964 in accordance with the instructions printed thereon and with these regulations. Such duplicate originals shall be filed by the shareholder or by the liquidating corporation with the Commissioner of Internal Revenue, Washington, D. C., attention of the Income Tax Unit, Records Division, within 30 days after the adoption of the plan of liquidation. A copy shall also be attached to and made a part of the shareholder's income tax return for his taxable year in which the transfer of all the property under the liquidation occurs.

ART. 112 (b) (7)-4. *Treatment of gain.*—(a) *Computation of gain.*—As in the case of shareholders generally, for the purpose of computing gain, amounts received by qualified electing shareholders are treated as in full payment in exchange for their stock, as provided in section 115 (c), and gain from the receipt of such amounts is determined as provided in section 111. Gain or loss must be computed separately on each share of stock owned by a qualified electing shareholder on the date of the adoption of the plan of liquidation. The limited recognition and special treatment accorded by section 112 (b) (7) applies only to the gain on such shares of stock upon which gain was realized and not to net gain computed by setting off losses realized on some shares against gain on others.

(b) *Recognition of gain.*—Pursuant to section 112 (b) (7) only so much of the gain on each share of stock owned by a qualified electing shareholder on the date of the adoption of the plan of liquidation is recognized as does not exceed the greater of the following—

(1) Such share's ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, computed as of December 31, 1938, without diminution by reason of distributions made during the month of December, 1938; or

(2) Such share's ratable share of the sum of the amount of money received by such shareholder on shares of the same class and the fair market value of all the stock or securities so received which were acquired by the liquidating corporation after April 9, 1938. The mere replacement after April 9, 1938, of lost or destroyed certificates or instruments acquired on or before April 9, 1938, or the mere conversion of certificates or instruments into certificates or instruments of larger or smaller denominations will not constitute an acquisition within the meaning of the phrase "acquired after April 9, 1938." Nor will such an acquisition result from the issuance after April 9, 1938, of certificates of stock in connection with a subscription made and accepted on or before April 9, 1938.

(c) *Treatment of recognized gain.*—In the case of a qualified electing shareholder other than a corporation that part of the recognized gain on a share of stock owned on the date of the adoption of the plan of liquidation which is not in excess of its ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, determined as provided in section

112 (b) (7) (E) (i) is treated and taxed to him as a dividend. It retains its character as a dividend for all tax purposes. The remainder of the gain which is recognized is treated and taxed to him as a short-term or long-term capital gain, as the case may be. In the case of a qualified electing shareholder which is a corporation, the entire amount of the gain which is recognized is treated and taxed as a capital gain.

Example: The X Corporation has only one class of stock outstanding, owned in equal amounts by three shareholders. The basis of the stock owned by each shareholder is $50, each having bought his stock in a single bloc prior to the date of the adoption of a plan of liquidation conforming to the requirements of section 112 (b) (7). One of such shareholders is an individual and two are corporations and all are qualified electing shareholders. The X Corporation has earnings and profits accumulated after February 28, 1913, of $60, its assets consisting of property (other than stock or securities acquired after April 9, 1938, and money) with a fair market value of $240, cash of $75, and stock and securities acquired after April 9, 1938, with a fair market value of $90, all of which assets are distributed in December, 1938, to the shareholders pro rata in complete liquidation of the corporation, as provided in section 112 (b) (7). Each shareholder, therefore, receives, in cash and property, $135 and his gain is $85.

In the case of each shareholder $55 of this gain is recognized, since such amount represents the sum of the cash received by him and the fair market value of the stock and securities received by him which were acquired by the X Corporation after April 9, 1938, and is greater than his ratable share of the earnings and profits ($20). In the case of the corporate shareholders this amount is treated as capital gain. In the case of the individual shareholder, however, $20, being the amount of the shareholder's ratable share of the earnings and profits, is taxable to him as a dividend, and $35, being the difference between the shareholder's ratable share of the earnings and profits and the sum of the cash and stock and securities received by him, is recognized and treated as a short-term or long-term capital gain, as the case may be. The remainder of each shareholder's gain, $30, is not recognized. If the basis of each shareholder's stock had been $100, instead of $50, the corporate shareholders would be taxed on only $35 as capital gain and the individual shareholder on $20 as a dividend but only on $15 as a capital gain, since the total amount taxed is limited by the amount of gain realized by the shareholder upon the cancellation or redemption of his stock.

ART. 112 (b) (7)–5. *Records to be kept and information to be filed with return.*—Permanent records in substantial form shall be kept by every qualified electing shareholder receiving distributions in complete liquidation of a domestic corporation. Such shareholder shall file with his income tax return for his taxable year in which the liquidation occurs a statement of all facts pertinent to the recognition and treatment of the gain realized by him upon the shares of stock owned by him on the date of the adoption of the plan of liquidation, including—

(*a*) A statement of his stock ownership in the liquidating corporation as of the date of the distribution, showing the number of shares of each class owned on such date and the cost or other basis of each such share;

(*b*) A list of all the property including money received upon the distribution, showing the fair market value of each item of such property other than money on the date distributed and stating what items, if any, consist of stock or securities acquired by the liquidating corporation after April 9, 1938;

(*c*) A statement of his ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, computed without diminution by reason of distributions made during the month of December, 1938; and

(*d*) A copy of such shareholder's written election to be governed by the provisions of section 112 (b) (7). (See article 112 (b) (7)–3.)

For information to be filed by the liquidating corporation, see section 148 (e).

[SEC. 112. *Recognition of gain or loss.*]
[(b) Exchanges solely in kind.—]

(8) *Exchanges and distributions in obedience to orders of securities and exchange commission.*—In the case of any exchange or distribution described in section 371, no gain or loss shall be recognized to the extent specified in such section with respect to such exchange or distribution.

[SEC. 112. *Recognition of gain or loss.*]
(*c*) *Gain from exchanges not solely in kind.*—(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

ART 112 (c)–1. *Receipt of other property or money in tax-free exchange not connected with corporate reorganization.*—If in any transaction in which (*a*) property held for investment or productive use in trade or business is exchanged for property of like kind to be held either for productive use or for investment; or (*b*) common stock is exchanged for common stock, or preferred stock for preferred stock, in the same corporation and not in connection with a corporate reorganization; or (*c*) property is transferred by one or more persons to a corporation for its stock or securities, within the meaning of section 112 (b) (5), there is received by the taxpayer other property (in addition to property permitted to be received without recognition of gain) or money, then

(1) The gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of the money and the fair market value of the other property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e)).

Example: A, who is not a dealer in real estate, in 1938 exchanges real estate, which he purchased (for investment) in 1921 for $5,000, for other real estate (to be held for productive use in trade or business) which has a fair market value of $6,000, and he receives in addition $2,000 in cash. The gain from the transaction is $3,000, but is recognized only to the extent of the cash received of $2,000.

See article 113 (a) (6)–1 for the basis for determining the gain or loss from the subsequent sale of the property received in exchanges such as described in this article.

As to the receipt of other property or money on an exchange of stock or securities in connection with a reorganization, and as to distributions in pursuance of a plan of reorganization which have the effect of a taxable dividend, see article 112 (g)–4.

[SEC. 112. *Recognition of gain or loss.*]
(*d*) *Same—Gain of corporation.*—If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

(*e*) *Loss from exchanges not solely in kind.*—If an exchange would be within the provisions of subsection (b) (1) to (5), inclusive, of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

ART. 112 (e)–1. *Nonrecognition of loss.*—The Act provides that in no event shall a loss be recognized from a tax-free exchange of property under section 112

(b) (1) to (5), inclusive, notwithstanding the fact that there is received in the exchange other property or money in addition to property permitted to be received without recognition of gain or loss.

As to the effect on the basis of the property received in such an exchange for the purpose of determining gain or loss from the subsequent sale thereof, see article 113 (a) (6)-1.

As to the nonrecognition of loss upon the receipt of property by one corporation in complete liquidation of another corporation under certain specifically described circumstances, see section 112 (b) (6).

[SEC. 112. *Recognition of gain or loss.*]

(*f*) *Involuntary conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

ART. 112 (f)-1. *Reinvestment of proceeds of involuntary conversion.*—In order to avail himself of the benefits of section 112 (f) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property converted. The benefits of section 112 (f) cannot be extended to a taxpayer who does not purchase other property similar or related in service or use, notwithstanding the fact that there was no other such property available for purchase.

If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens and mortgages against the property and itself pays the same, the amount so retained should be included in determining the amount of the net award. An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

The provisions of section 112 (f) are applicable to property used for residential or farming purposes.

The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

There is no investment in property similar in character and devoted to a similar use if—

(1) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(2) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold.

(3) The owner of a requisitioned tug uses the proceeds to buy barges.

(4) An award for property taken for street widening is applied toward payment of special assessments for benefits accruing to the remaining property.

It is incumbent upon a taxpayer "forthwith" to apply for and receive permission to establish a replacement fund in every case where it is not possible to replace immediately. If an expenditure in actual replacement would be too late, a request for the establishment of a replacement fund would likewise be too late.

ART. 112 (f)-2. *Replacement funds.*—In any case where the taxpayer elects to replace or restore the converted property but it is not practicable to do so immediately, he may obtain permission to establish a replacement fund in his accounts in which part or all of the compensation so received shall be held, without deduction for the payment of any mortgage. In such a case the taxpayer should make application to the Commissioner on Form 1114 for permission to establish such a replacement fund, and in his application should recite all the facts relating to the transaction and declare that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require in an amount not in excess of double the estimated additional income taxes which would be payable if no replacement fund were established. See section 1126 of the Revenue Act of 1926, as amended (paragraph 35 of the Appendix to these regulations), providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. The estimated additional taxes, for the amount of which the applicant is required to furnish security, should be computed at the rates at which the applicant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant, and the surety or depositary may each have a copy.

[SEC. 112. *Recognition of gain or loss.*]

(*g*) *Definition of reorganization.*—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

ART. 112 (g)-1. *Purpose and scope of exception of reorganization exchanges.*—*Purpose:* Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Act is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Act, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Act are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Act recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. The Act recognizes as a reorganization the amalgamation (occuring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Act, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up.

Scope: The nonrecognition of gain or loss is prescribed for two specifically described types of exchanges, viz: The exchange that is provided for in section 112 (b) (3) in which stock or securities in a corporation a party to the reorganization are, in pursuance of a plan of reorganization, exchanged for the stock or securities in a corporation a party to the same reorganization; and the exchange that is provided for in section 112 (b) (4) in which a corporation a party to the reorganization exchanges property, in pursuance of a plan of reorganization, for stock or securities in another corporation a party to the same reorganization. Section 112 (g) limits the definition of the term "reorganization" to five kinds of transactions and excludes all others. From its context, the term "a party to a reorganization" can only mean a party to a transaction specifically defined as a reorganization by section 112 (g). Certain rules respecting boot received in either of the two types of exchanges provided for in section 112 (b) (3) and (4) are prescribed in subsections (c) and (d) of section 112. Under section 112 (i) a limitation is placed on all these provisions by providing that except under specified conditions foreign corporations shall not be deemed within their scope.

The provisions of the Act referred to in the preceding paragraph of this article are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 112 (g) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme which involves an abrupt departure from normal reorganization procedure, devised and adopted with reference to a transaction on which the imposition of the tax is imminent, is not a plan of reorganization.

ART. 112 (g)-2. *Definition of terms.*—The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112 (g) (1). The term does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its stockholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange.

The words "statutory merger or consolidation" refer to a merger or consolidation effected in pursuance of the corporation laws of the United States or a State or Territory or the District of Columbia.

In order to qualify as a "reorganization" under section 112 (g) (1) (B), the acquisition by the acquiring corporation of the required amount of the stock, or of substantially all the properties, of the other corporation must be in exchange *solely* for all or a part of the *voting stock* of the acquiring corporation. If, for example Corporation X exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of the required amount of stock, or of the properties, of Corporation Y, the transaction is not a "reorganization" under section 112 (g) (1) (B).

A "recapitalization," and therefore a reorganization, takes place if, for example,

(1) A corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders;

(2) There is surrendered to a corporation for cancellation 25 percent of its preferred stock in exchange for no par value common stock;

(3) A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock; or

(4) An exchange is made of a corporation's outstanding preferred stock, having certain priorities with reference to the amount and time of payment of dividends and the distribution of the corporate assets upon liquidation, for a new issue of such corporation's common stock having no such rights.

The term "a party to a reorganization" includes, in addition to a corporation which performs the specific act constituting the reorganization as described and defined in section 112 (g) (1), only a corporation specified in section 112 (g) (2). Both corporations are parties to the reorganization if under statutory authority Corporation A is merged into Corporation B; and all three of the corporations are parties to the reorganization if, pursuant to statutory authority, Corporations C and D are consolidated into Corporation E. Both corporations are parties to the reorganization if it consists of the transfer by Corporations F and G of part of the assets of Corporation F in exchange for all of the capital stock of Corporation G. Only Corporations H and J are parties to the reorganization if it consists of the acquisition by Corporation H in exchange solely for all or a part of its voting stock of at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all other classes of stock of Corporation J, even though such acquisition by Corporation H is from Corporation K.

The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under section 112 (g) (1). The term is not to be construed as broadening the definition of "reorganization" as set forth in section 112 (g) (1), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges as are directly a part of the transaction specifically described as a reorganization in that subsection. Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 112 (g) (1), but the readjustments involved in the exchanges effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 112 (g) (1) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

As used in section 112, as well as in other provisions of the Act, if the context so requires, the conjunction "or" denotes both the conjunctive and the disjunctive, and the singular includes the plural. For example, the provisions of the statute are complied with if "stock *and* securities" are received in exchange as well as if "stock *or* securities" are received.

ART. 112 (g)-3. *Exchanges solely of stock or securities, or property, solely for stock or securities, in pursuance of plan of reorganization.*—No taxable income is received, nor is a deductible loss sustained, if the shareholders in a corporation a party to the following reorganization transactions exchange stock or securities solely for stock or securities of the same corporation, or of another corporation mentioned, or if one of such corporations transfers property to another of the corporations solely for stock or securities of such other corporation, in pursuance of the plan of reorganization:

(1) The merger of Corporation A, in accordance with statutory authority, into Corporation B;

(2) The consolidation, pursuant to statutory authority, of Corporations C and D into Corporation E, a new corporation;

(3) The acquisition by Corporation F, in exchange solely for all or a part of its voting stock, of at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all other classes of the stock of Corporation G, or substantially all of the properties of Corporation G;

(4) The transfer by Corporation H of all or a part of its assets to Corporation K, if immediately after the transfer Corporation H or its stockholders, or both, are in control of Corporation K ("control" for the purpose of this transaction being defined in section 112 (h) as the

ownership by Corporation H or its stockholders, or both, of the stock of Corporation K to the extent of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes thereof); or

(5) The exchange of stock or securities solely for stock or securities of the same corporation in the case of (*a*) a recapitalization of a corporation, or (*b*) a mere change in the identitfy, form, or place of organization of a corporation, however effected.

ART. 112 (g)-4. *Exchanges in reorganization for stock or securities and other property or money.*—If in an exchange of stock or securities in a corporation a party to a reorganization, in pursuance of the plan of reorganization, for stock or securities in the same corporation or in another corporation a party to the reorganization, there is received by the taxpayer other property (not permitted to be received without the recognition of gain) or money, then

(1) As provided in section 112 (c) (1), the gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of money and the fair market value of the other property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e)).

Example: A, in connection with a reorganization, in 1938, exchanges a share of stock in the X Corporation purchased in 1928 at a cost of $100 for a share of stock of the Y Corporation (a party to the reorganization), which has a fair market value of $90, plus $20 in cash. The gain from the transaction is $10 and is recognized and taxed as a gain from the exchange of property. But see section 117. However, if the share of stock received had a fair market value of $70, the loss from the transaction of $10 would not be recognized.

If the distribution of such other property or money by or on behalf of a corporation in the course of a reorganization has the effect of the distribution of a taxable dividend, then, as provided in section 112 (c) (2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) as a gain from the exchange of property, the remainder of the gain so recognized.

Example: The X Corporation has a capital of $100,000 and earnings and profits of $50,000 accumulated since February 28, 1913. The X Corporation in 1938 transfers all of its assets to the Y Corporation in exchange for the issuance of all of the stock of the Y Corporation and the payment of $50,000 in cash to the stockholders of the X Corporation. A, who owns one share of stock in the X Corporation, for which he in 1928 paid $100, receives a share of stock in the Y Corporation worth $100 and the sum of $50 in cash in addition. A gain of $50 is recognized to A.

If, in pursuance of a plan of reorganization, property is exchanged by a corporation a party to the reorganization for stock or securities in another corporation a party to the reorganization and other property or money, then, as provided in section 112 (d) (1), if the other property or money received by the corporation is distributed by it pursuant to the plan of reorganization, no gain to the corporation will be recognized. If the other property or money received by the corporation is not distributed by it pursuant to the plan of reorganization, the gain, if any, to the corporation from the exchange will be recognized, under the provisions of section 112 (d) (2), in an amount not in excess of the sum of money and the fair market value of the other property so received which is not distributed. In either case no loss from the exchange will be recognized (see section 112 (e)).

ART. 112 (g)-5. *Receipt of stock or securities in reorganization without surrender of stock by shareholder.*—Any distribution, though in pursuance of a plan of reorganization, to its shareholders without the surrender of their stock, by or on behalf of a corporation a party to a reorganization, of its stock or securities (other than its own stock, which is not taxable as a dividend under section 115 (f)) or of stock or securities of another corporation a party to the reorganization, shall be taxed to such shareholders as a dividend, within the meaning of section 115, to the extent that the fair market value of such stock or securities at the date of the distribution is not in excess of (1) the earnings or profits of the corporation of the taxable year computed without regard to prior years and (2) the earnings or profits of the corporation accumulated after February 28, 1913, and prior to the taxable year. Any remainder of such fair market value of the stock or securities distributed over the amount of such earnings or profits shall be applied against and used to reduce the basis provided in section 113 of the stock in respect of which the distribution was made; and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. (See article 111-1.)

ART. 112 (g)-6. *Records to be kept and information to be filed with returns.*—(*a*) The plan of reorganization must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of the corporation. Each corporation a party to a reorganization shall file as a part of its return for its taxable year within which the reorganization occurred a complete statement of all facts pertinent to the nonrecognition of gain or loss in connection with the reorganization, including—

1. A certified copy of the plan of reorganization, together with a statement under oath showing in full the purposes thereof and in detail all transactions incident to, or pursuant to, the plan.

2. A complete statement of the cost or other basis of all property, including all stock or securities, transferred incident to the plan.

3. A statement of the amount of stock or securities and other property or money received from the exchange, including a statement of all distributions or other disposition made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the exchange.

(*b*) Every taxpayer, other than a corporation a party to the reorganization, who receives stock or securities and other property or money upon a tax-free exchange in connection with a corporate reorganization shall incorporate in his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

1. A statement of the cost or other basis of the stock or securities transferred in the exchange, and

2. A statement in full of the amount of stock or securities and other property or money received from the exchange. The amount of each kind of stock or securities and other property received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(*c*) Permanent records in substantial form shall be kept by every taxpayer who participates in a tax-free exchange in connection with a corporate reorganization showing the cost or other basis of the transferred property and the amount of stock or securities and other property or money received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.

[SEC. 112. *Recognition of gain or loss.*]

(*h*) *Definition of control.*—As used in this section the term "control" means the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

ART. 112 (h)-1. *Control of corporation.*—Section 112 (h) defines the term "control" in reference to the phrase "control of the corporation," as used in section 112 (b) (5) and section 112 (g) (1). It is provided specifically that this definition is limited to the meaning of the term "control" as that term is used in section 112.

[SEC. 112. *Recognition of gain or loss.*]
(*i*) *Foreign corporations.*—In determining the extent to which gain shall be recognized in the case of any of the exchanges described in subsection (b) (3), (4), (5), or (6), or described in so much of subsection (c) as refers to subsection (b) (3) or (5), or described in subsection (d), a foreign corporation shall not be considered as a corporation unless, prior to such exchange, it has been established to the satisfaction of the Commissioner that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

ART. 112 (i)-1. *Reorganization with, or transfer of property to, a foreign corporation.*—A foreign corporation will not be considered a corporation to which a tax-free transfer of property for stock or securities may be made, or a corporation a party to a reorganization with which a tax-free reorganization exchange may be made, or a corporation a party to which a tax-free liquidation distribution may be made, unless, prior to the transfer, exchange, or liquidation, it has been established to the satisfaction of the Commissioner that such transfer, exchange, or liquidation, is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. The term "Federal income taxes" includes the excess-profits tax on the net income of a corporation referred to in section 106 of the Revenue Act of 1935, section 402 of the Revenue Act of 1936, and section 602 of the Revenue Act of 1938.

Whether any of the exchanges or distributions referred to in section 112 (i), involving a foreign corporation, is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income or excess-profits taxes, is a question to be determined from the facts and circumstances of each particular case. In any such case if a taxpayer desires to establish that the exchange or distribution is not in pursuance of such a plan, a statement under oath of the facts relating to the plan under which the exchange or distribution is to be made, together with a copy of the plan, shall be forwarded to the Commissioner of Internal Revenue, Washington, D. C., for a ruling. A letter setting forth the Commissioner's determination will be mailed to the taxpayer. If the Commissioner determines that the exchange or distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income or excess-profits taxes, the taxpayer should retain a copy of the Commissioner's letter as authority for treating the foreign corporation as a corporation in determining the extent to which gain is recognized from the exchange or distribution. If the reorganization or the transfer is not carried out in accordance with the plan submitted, the Commissioner's approval will not render the transaction tax-free.

[SEC. 112. *Recognition of gain or loss.*]
(*j*) *Installment obligations.*—For nonrecognition of gain or loss in the case of the installment obligations, see section 44 (d).

SEC. 113. *Adjusted basis for determining gain or loss.*—(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

ART. 113 (a)-1. *Scope of basis for determining gain or loss.*—The basis of property for the purpose of determining gain or loss from the sale or other disposition thereof is the unadjusted basis prescribed in section 113 (a), adjusted for the various applicable items specified in section 113 (b). Unless otherwise indicated, the word "basis," as used in this article and articles 113 (a)-2 to 113 (a) (18)-1, inclusive, has reference to the unadjusted basis.

ART. 113 (a)-2. *General rule.*—In general, the basis of property is the cost thereof. This rule is subject, however, to the exceptions stated in paragraphs (1) to (18) of section 113 (a).

[SEC. 113. *Adjusted basis for determining gain or loss.*]
[(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(1) *Inventory value.*—If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

ART. 113 (a) (1)-1. *Property included in inventory.*—The last inventory value of property which should be included in inventory is the basis of such property. The requirements with respect to the valuation of an inventory are stated in articles 22 (c)-1 to 22 (d)-4, inclusive.

[SEC. 113. *Adjusted basis for determining gain or loss.*]
[(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(2) *Gifts after December 31, 1920.*—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower. If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information that the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner.

ART. 113 (a) (2)-1. *Property transmitted by gift after December 31, 1920*—(*a*) *Property included.*—Section 113 (a) (2) applies to all property acquired after December 31, 1920, by gift, whether by transfer in trust or otherwise. It does not apply to property acquired by

(1) devise or bequest (see section 113 (a) (5)); or

(2) an instrument which, under section 113 (a) (5), is to be treated as though it were a will.

Section 113 (a) (2) applies to all gifts of whatever description; whether by a transfer in trust or otherwise; whenever and however made, perfected, or taking effect; whether in contemplation of or intended to take effect in possession or enjoyment at or after the donor's death; whether subject at any time to any change through the exercise of any power of appointment, revocation or otherwise; or whether made by means of the exercise (other than by will) of a power of appointment or revocation, or any other power.

(*b*) *Basis.*—For the purpose of determining gain, the basis is the same as it would be in the hands of the donor, or the last preceding owner by whom it was not acquired by gift. For the purpose of determining loss, the basis is as so determined, or the fair market value of the property at the time of the gift, whichever is lower.

All titles to property acquired by gift relate back to the time of the gift, even though the interest of him who takes the title was, at the time of the gift, legal, equitable, vested, contingent, conditional, or otherwise. Accordingly, all property acquired by gift is acquired at the time of the gift. In the hands of every person acquiring property by gift, the basis is always the same, whether such person be the trustee under the gift instrument, the beneficiary, or any other person to whom such uniform basis is applicable, and whether during the term of the trust or after distribution of the trust corpus. Adjustments to basis, as required by section 113 (b), are to be made as respects the period prior to the gift, and the period after the gift. With respect to the latter period, the adjustments to the uniform basis are to be made in accordance with paragraph (*e*) of article 113 (a) (5)-1.

The time of the gift is the time when the gift is consummated. Delivery, actual or constructive, is requisite to a gift. In determining the time of the gift, the passing of title by the donor is not decisive; the time when the donor relinquishes substantial dominion over the property is decisive.

(*c*) *Fair market value.*—For the purposes of this article, the value of property as appraised for the purpose of the Federal gift tax, or if the gift is not subject to such tax, its value as appraised for the purpose of a State gift tax shall be deemed to be the fair market value of the property at the time of the gift.

(*d*) *Reinvestments by fiduciary.*—If the property is an investment by the fiduciary under the instrument of gift (as, for example, in the case of a sale by the fiduciary of property transferred under the instrument of gift, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (*b*).

(*e*) *Records.*—To insure a fair and adequate determination of the proper basis under section 113 (a) (2), persons making or receiving gifts of property should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value as of March 1, 1913.

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(3) *Transfer in trust after December 31, 1920.*—If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a bequest or devise) the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made.

ART. 113 (a) (3)-1. *Transfer in trust after December 31, 1920.*—(*a*) *Property included.*—Section 113 (a) (3) applies in general to all property acquired after December 31, 1920, by transfer in trust. It does not apply to property acquired as a *gift* by transfer in trust, or by bequest or devise; or by an instrument which, under section 113 (a) (5), is to be treated as though it were a will. With these exceptions, section 113 (a) (3) applies to all property acquired after December 31, 1920, by any transfer in trust of whatever description. If the transfer in trust be a gift, it is not within section 113 (a) (3), but is within section 113 (a) (2) or section 113 (a) (4).

(*b*) *Basis.*—The basis of property so acquired is the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by a transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether prior to the termination of the trust and distribution of the property, or thereafter.

(*c*) *Reinvestments by fiduciary.*—If the property is an investment made by the fiduciary (as, for example, in the case of a sale by the fiduciary of property transferred by the grantor, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (*b*).

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(4) *Gift or transfer in trust before January 1, 1921.*—If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

ART. 113 (a) (4)-1. *Gift or transfer in trust prior to January 1, 1921.*—(*a*) *Property included.*—Section 113 (a) (4) applies to all property acquired before January 1, 1921, by gift or transfer in trust. It does not apply to property acquired by a devise or bequest; or by an instrument which, under section 113 (a) (5) is to be treated as though it were a will.

(*b*) *Basis.*—The basis is the fair market value of such property at the time of the gift or at the time of the transfer in trust. Such fair market value is to be ascertained in the manner prescribed in paragraph (c) of article 113 (a) (2)-1, or by equivalent methods.

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(5) *Property transmitted at death.*—If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition. In the case of property transferred in trust to pay the income for life to or upon the order or direction of the grantor, with the right reserved to the grantor at all times prior to his death to revoke the trust, the basis of such property in the hands of the persons entitled under the terms of the trust instrument to the property after the grantor's death shall, after such death, be the same as if the trust instrument had been a will executed on the day of the grantor's death. For the purpose of this paragraph property passing without full and adequate consideration under a general power of appointment exercised by will shall be deemed to be property passing from the individual exercising such power by bequest or devise. If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, and if the decedent died after August 26, 1937, and if the property consists of stock or securities of a foreign corporation, which with respect to its taxable year next preceding the date of the decedent's death was, under the law applicable to such year, a foreign personal holding company, then the basis shall be the fair market value of such property at the time of such acquisition or the basis in the hands of the decedent, whichever is lower.

ART. 113 (a) (5)-1. *Basis of property acquired by bequest, devise, or inheritance.*—(*a*) *Property included.*—Section 113 (a) (5) applies—

(1) to all property passing from a decedent by his will or under the law governing the descent and distribution of property of decedents; and

(2) to property passing under an instrument which, under section 113 (a) (5) is treated as though it were a will, but applies to such property only at the times and to the extent prescribed in section 113 (a) (5).

(*b*) *Basis.*—Section 113 (a) (5) provides two rules for determining the basis of property transmitted at death, a rule governing property generally and a special rule governing stock in a foreign personal holding company.

(1) *General rule.*—Except as prescribed in paragraph (2) the basis of property acquired from a decedent by will or under the law governing the descent and distribution of the property of decedents is the fair market value at the time of such acquisition. Since under the law governing wills and the distribution of the property of decedents, all titles to property acquired by bequest, devise, or inheritance relate back to the death of the decedent, even though the interest of him who takes the title was, at the date of death of the decedent, legal, equitable, vested, contingent, general, specific, residual, conditional, executory, or otherwise, the time of the acquisition of such property is the death of the decedent. For example, if distribution of personal property left by a decedent is not made until one year after his death, the basis of such property in the hands of the legatee is its fair market value at the time when the decedent died, and not when the legatee actually received the property; or, if the bequest is of the residue to trustees in trust, and the executors do not distribute the residue to such trustees until five years after the death of the decedent, the basis of each piece of property left by the decedent and thus received, in the hands of the trustees, is its fair market value at the time when the decedent dies; or, if the bequest is to trustees in trust to pay to A during his lifetime the income of the property bequeathed, and after his death to distribute such property to the survivors of a class, and upon A's death the property is distributed to the taxpayer as the sole survivor, the basis of such property, in the hands of the taxpayer, is its fair market value at the time when the decedent died.

The purpose of the Act, in prescribing a general uniform basis rule for property acquired by bequest, devise, or inheritance, is, on the one hand, to tax the gain, in respect of such property, to him who realizes it (without regard to the circumstance that at the death of the decedent it may have been quite uncertain whether the taxpayer would take or gain anything); and, on the other hand, not to recognize as gain any element of value solely from the circumstance that the possession or enjoyment of the taxpayer was postponed. Such postponement may be, for example, until the administration of the decedent's estate is completed, until the period of the possession or enjoyment of another has terminated, or until an uncertain event has happened. It is the increase or decrease in the value of property reflected in a sale or other disposition which section 113 (a) (5) recognizes as the measure of gain or loss.

(2) *Special rule with respect to stock in a foreign personal holding company.*—In the case of decedents dying after August 26, 1937, the basis of stock of a foreign corporation acquired from the

decedent by will or under the law governing descent and distribution of property of decedents, where such foreign corporation with respect to its taxable year next preceding the date of the decedent's death was a foreign personal holding company, is the fair market value of such stock at the time of such acquisition, i. e., the date of the decedent's death, or the basis in the hands of the decedent (with proper adjustments to the date of the decedent's death), whichever is lower.

(c) *Fair market value.*—For the purposes of this article, the value of property as of the date of the death of the decedent as appraised for the purpose of the Federal estate tax or if the property is not appraised as of the date of death of the decedent for such purpose or if the estate is not subject to such tax, its value as appraised as of the date of the death of the decedent for the purpose of State inheritance or transmission taxes, shall be deemed to be its fair market value at the time of the death of the decedent.

(d) *Property acquired before March 1, 1913; reinvestments by fiduciary.*—If the decedent died before March 1, 1913, the fair market value on that date is taken in lieu of the fair market value on the date of death, but only to the same extent and for the same purposes as the fair market value on March 1, 1913, is taken under section 113 (a) (14).

If the property is an investment by the fiduciary under a will (as, for example, in the case of a sale by a fiduciary under a will of property transmitted from the decedent, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the fair market value at the time when the decedent died.

(e) *Adjustments to basis.*—In the hands of every person who acquires the property of a decedent (or any estate or interest therein) by bequest, or devise, or inheritance, the basis of the property is always the same,

(1) whether such person be the executor or administrator, the heir, the legatee, the devisee, the trustee of a trust created by the will, or any beneficiary of such trust, and whatever the nature of any such person's interest or estate may be;

(2) whether during or after administration and settlement of the estate of the decedent, during or after the term of any trust under the will, or before or after the distribution by the executor or administrator, or the trustee.

Adjustments to basis required by section 113 (b) are made in accordance with the same principles. Thus the deductions for depreciation and for depletion allowed or allowable, under section 23 (l) and section 23 (m), to a legal life tenant as if the life tenant were the absolute owner of the property, constitute an adjustment to the basis of the property in the hands not only of the life tenant, but also in the hands of the remainderman and every other person to whom the same uniform basis is applicable. Similarly, the deductions allowed or allowable under section 23 (l) and section 23 (m), both to the trustee and to the trust beneficiaries, constitute an adjustment to the basis of the property not only in the hands of the trustee, but also in the hands of the trust beneficiaries and every other person to whom the uniform basis is applicable. See, however, section 24 (a). Similarly, adjustments in respect of capital expenditures or losses, tax-free distributions, or other distributions applicable in reduction of basis, or other items for which the basis is adjustable are made without regard to which one of the persons to whom the same uniform basis is applicable makes the capital expenditures or sustains the capital losses, or to whom the tax-free or other distributions are made, or to whom the deductions are allowed or allowable.

The executor or other legal representative of the decedent, the fiduciary of a trust under a will, the life tenant and every other person to whom a uniform basis under this article is applicable, shall make and maintain records showing in detail all deductions, distributions, or other items for which adjustment to basis is required to be made by section 113 (b), and shall furnish to the Commissioner information with respect to such matters in such detail at such time and in such manner as the Commissioner may require.

(f) *Sales of remainder and other interests in property transmitted at death.*—The following is an illustration of the rule stated in paragraph (b) of this article that, under section 113 (a) (5), the measure of gain or loss resulting from a sale or other disposition of property transmitted at death is the increase or decrease in the value of the property as reflected in such sale or other disposition: If land is left for life to A, with remainder in fee to B, and prior to A's death, B sells his remainder, the increase or decrease in the value of the land reflected, and realized by B, in the proceeds from the sale of his remainder interest constitutes the gain recognized upon the sale. (See section 111.) Such gain (or as the case may be, the loss) is computed by comparing the amount of the proceeds received from the sale with the amount of the part of the uniform basis assignable to such sale of B's remainder interest. The part of the uniform basis assignable to such a sale by B is the part of the uniform basis (adjusted to the time of the sale) of the land transmitted from the decedent which bears the same proportion to such uniform basis as B's remainder interest, at the time of the sale, bears to the whole estate in the land transmitted from the decedent.

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(6) *Tax-free exchanges generally.*—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis (except as provided in paragraph (15), (17), or (18) of this subsection) shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112 (b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

ART. 113 (a) (6)-1. *Property acquired upon a tax-free exchange.*—In the case of an exchange, after February 28, 1913, of property solely of the type described in section 112 (b), if no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

If, in an exchange, after February 28, 1913, of properties of the type indicated in section 112 (b), gain to the taxpayer was recognized under the provisions of section 112 (c) or (d) or a similar provision of a prior Revenue Act, on account of the receipt of money in addition in the transaction, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange. For example: A purchased a share of stock in the X Corporation in 1926 for $100. Pursuant to a plan of reorganization, A in 1938 exchanged his share for one share in the Y Corporation, worth $90, and $30 in cash. Under the provisions of section 112 (c), A realized a taxable gain of $20 from the exchange. As to the amount of such gain to be taken into account in computing net income, see section 117. The basis of the share of stock in the Y Corporation is $90; that is, the basis of the share in the X Corporation ($100) less the amount of money received by A ($30) plus the amount of gain recognized on the exchange ($20).

If, upon an exchange of properties of the type described in section 112 (b), there was received by the taxpayer in addition other property (not permitted to be received without the recognition of gain) and money, and gain from the transaction was recognized as required under section 112 (c) or (d) or a similar provision of a prior Revenue Act, the basis (adjusted to the date of the exchange of the property transferred by the taxpayer, decreased by the amount of money received and increased by the amount of gain recognized, must be apportioned to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of such basis to the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange.

Example: A purchased a share of stock in the X Corporation in 1924 for $100. Upon a reorganization of the X Corporation in 1938, A received in place of his stock in the X Corporation a share of stock in the Y Corporation worth $60, a Treasury bond worth $50, and in addition $20 in cash. Under section 112 (c) (1), A realized a gain of $30 from the exchange. As to the amount of such gain to be taken into account in computing net income, see section 117. The basis of the property received in exchange is the basis of the old stock ($100) decreased in the amount of money received ($20) and increased in the amount of gain that was realized ($30), which results in a basis for the property received of $110. This basis of $110 is apportioned between the Treasury bond and the share of stock, the basis of the Treasury bond being its fair market value at the date of the exchange, $50, and of the share of stock, the remainder, $60.

Section 112 (e) of the Act, and similar provisions of prior Revenue Acts, provide that no loss may be recognized on an exchange of properties of a type described in section 112 (b), although the taxpayer receives other property or money from the transaction. However, the basis of the property or properties received by the taxpayer (other than money) is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be apportioned to the properties received, and for this purpose there must be allocated to such other property (not permitted to be exchanged tax free) an amount of such basis equivalent to the fair market value of such other property at the date of the exchange.

Paragraph (6) of section 113 (a) does not apply in ascertaining the basis of property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it. But see paragraphs (7) and (8) of section 113 (a).

[Sec. 113. *Adjusted basis for determining gain or loss.*]

[(*a*) *Basis* (*unadjusted*) *of property.*—The basis of property shall be the cost of such property; except that—]

(7) *Transfers to corporation.*—If the property was acquired—

(A) after December 31, 1917, and in a taxable year beginning before January 1, 1936, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, or

(B) in a taxable year beginning after December 31, 1935, by a corporation in connection with a reorganization,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

Art. 113 (a) (7)-1. *Property acquired by corporation in reorganization after December 31, 1917.*—Section 113 (a) (7) sets forth the conditions under which the basis of property acquired by a corporation after December 31, 1917, in connection with a reorganization as defined in section 112 is the same as it would be in the hands of the transferor, increased or decreased as therein provided in the amount of gain or loss recognized to the transferor under the applicable revenue law. In the case of property so acquired in a taxable year beginning prior to January 1, 1936, such basis is applicable only if immediately after the transfer there remained in the same persons or any of them an interest or control in such property of 50 percent or more. In the case, however, of property so acquired in a taxable year beginning after December 31, 1935, section 113 (a) (7) is applicable irrespective of the extent of the interest or amount of control in such property remaining, immediately after the transfer, in the hands of the same persons or any of them.

The application of the provisions of section 113 (a) (7) (A) may be illustrated by the following examples:

Example (1): In 1925 the X Corporation caused the organization of the Y Corporation and transferred to the Y Corporation, in exchange for all the capital stock of that corporation, property which it had previously purchased for $10,000. The basis of the property in the hands of the Y Corporation is $10,000.

Example (2): In 1925 the M Corporation exchanged 10 percent of its voting stock for all the property of the N Corporation which had a basis of $10,000 in the hands of the N Corporation. The basis of the property in the hands of the M Corporation is cost thereof to it at the time of the transfer, that is, the fair market value of the M stock exchanged for the property.

Section 113 (a) (7) does not apply if, irrespective of when acquired, the property consists of stock or securities in a corporation a party to a reorganization as defined in section 112, unless such stock or securities are acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer. The application of the last sentence of section 113 (a) (7) to a case where such stock or securities are acquired by the issuance of stock or securities of the transferee may be illustrated as follows:

Example (3): The Y Corporation owns all of the stock of the X Corporation, which stock it acquired in 1938 by the issuance of all of its own voting stock to the individual shareholders of the X Corporation. The stock of the X Corporation was acquired by the individuals in 1924 for $200,000 in cash. The stock of the Y Corporation had a fair market value of $1,000,000 at the time it was exchanged in 1938 for the stock of the X Corporation. The fair market value of the stock of the X Corporation at the time of the exchange in 1938 was also $1,000,000. The basis to the Y Corporation of the stock of the X Corporation is the basis which such stock would have had in the hands of the individuals from which it was acquired by the Y Corporation, that is, $200,000.

[Sec. 113. *Adjusted basis for determining gain or loss.*]

[(*a*) *Basis* (*unadjusted*) *of property.*—The basis of property shall be the cost of such property; except that—]

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

Art. 113 (a) (8)-1. *Property acquired by a corporation after December 31, 1920.*—The acquisition of property by a corporation after December 31, 1917, by the issuance of its stock or securities may not fall within the provisions of paragraph (7) of section 113 (a), because of the fact that the property was not acquired in connection with a reorganization. If, however, the acquisition of such property occurred after December 31, 1920, and falls within the provisions of paragraph (8) of section 113 (a), the limitations therein imposed upon the basis of such property are applicable.

In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. In the case of property acquired by a corporation after December 31, 1920, as a gift, the basis thereof shall be determined under section 113 (a) (2).

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(9) *Involuntary conversion.*—If the property was acquired, after February 28, 1913, as a result of a compulsory or involuntary conversion described in section 112 (f), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made.

ART. 113 (a) (9)-1. *Property acquired as a result of an involuntary conversion.*—The provisions of section 113 (a) (9) may be illustrated by the following example:

Example: A vessel purchased by A in 1926 for $100,000 is destroyed in 1938 and A receives insurance in the amount of $200,000. Disregarding, for the purpose of this example, the adjustment for depreciation, if A invests $150,000 in a new vessel, taxable gain to the extent of $50,000 would be recognized. The basis of the new vessel is $100,000; that is, the cost of the old vessel ($100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel ($50,000) plus the amount of gain recognized upon the conversion ($50,000). If any amount in excess of the proceeds of the conversion is expended in the acquisition of the new property, such amount may be added to the basis otherwise determined.

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(10) *Wash sales of stock.*—If the property consists of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 118 of this Act or corresponding provisions of prior income tax laws, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, then the basis shall be the basis of the stock or securities so sold or disposed of, increased or decreased, as the case may be, by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold or otherwise disposed of.

ART. 113 (a) (10)-1. *Stocks or securities acquired in "wash sales."*—The application of section 113 (a) (10) may be illustrated by the following examples:

Example (1): A purchased a share of common stock of the X Corporation for $100 in 1926, which he sold January 15, 1938, for $80. On February 1, 1938, he purchased a share of common stock of the same corporation for $90. No loss from the sale is recognized under section 118. The basis of the new share is $110; that is, the basis of the old share ($100) increased by $10, the excess of the price at which the new share was acquired ($90) over the price at which the old share was sold ($80).

Example (2): A purchased a share of common stock of the Y Corporation for $100 in 1926, which he sold January 15, 1938, for $80. On February 1, 1938, he purchased a share of common stock of the same corporation for $70. No loss from the sale is recognized under section 118. The basis of the new share is $90; that is, the basis of the old share ($100) decreased by $10, the excess of the price at which the old share was sold ($80) over the price at which the new share was acquired ($70).

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(11) *Property acquired during affiliation.*—In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such period of affiliation, shall be determined, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, without regard to intercompany transactions in respect of which gain or loss was not recognized. For the purposes of this paragraph, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto) but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928. The basis in case of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928 or the Revenue Act of 1932 or the Revenue Act of 1934 or the Revenue Act of 1936, shall be determined in accordance with regulations prescribed under section 141 (b) of this Act or the Revenue Act of 1928 or the Revenue Act of 1932 or the Revenue Act of 1934 or the Revenue Act of 1936. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928 or the Revenue Act of 1932 or the Revenue Act of 1934 or the Revenue Act of 1936, shall be adjusted in respect of any items relating to such period, in accordance with regulations prescribed under section 141 (b) of this Act or the Revenue Act of 1928 or the Revenue Act of 1932 or the Revenue Act of 1934 or the Revenue Act of 1936, applicable to such period.

ART. 113 (a) (11)-1. *Basis of property acquired during affiliation.*—The basis of property acquired by a corporation during a period of affiliation from a corporation with which it was affiliated shall be the same as it would be in the hands of the corporation from which acquired. This rule is applicable if the basis of the property is material in determining tax liability for any year, whether a separate return or a consolidated return is made in respect of such year. For the purpose of this article, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto, but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928.

Example: The X Corporation, the Y Corporation, and the Z Corporation were affiliated for the taxable year 1920. During that year the X Corporation transferred assets to the Y Corporation for $120,000 cash, and the Y Corporation in turn transferred the assets during the same year to the Z Corporation for $130,000 cash. The assets were acquired by the X Corporation in 1916 at a cost of $100,000. The basis of the assets in the hands of the Z Corporation is $100,000.

The basis of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made or was required under Regulations 75, Regulations 78, Regulations 89, Regulations 97, or Regulations 102, relating to consolidated returns, shall be determined in accordance with such regulations. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made or is required under Regulations 75, Regulations 78, Regulations 89, Regulations 97, or Regulations 102, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

The basis of property after a consolidated return period shall be the same as immediately prior to the close of such period. For example, if a corporation has been a member of an affiliated group which has made a consolidated return on the calendar year basis for the taxable year 1937 and makes a separate return for the taxable year 1938 and succeeding taxable years, the value of the opening inventory to be used in computing such corporation's net income for the taxable year 1938 is the proper value of the closing inventory used in computing the consolidated net income for the preceding taxable year.

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(12) *Basis established by Revenue Act of 1932.*—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932 was prescribed by section 113 (a) (6), (7), or (9) of such Act, then for the purposes of this Act the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

ART. 113 (a) (12)-1. *Basis of property established by Revenue Act of 1932.*—Section 113 (a) (12) provides that if the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis of the property, for the purposes of the

Revenue Act of 1932, was prescribed by section 113 (a) (6), (7), or (9) of that Act, then for the purposes of the Revenue Act of 1938 the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

If, after December 31, 1923, and in any taxable year beginning prior to January 1, 1934, in pursuance of a plan of reorganization and without the surrender of his stock, there was distributed to a shareholder in a corporation a party to the reorganization stock or securities of a corporation a party to the reorganization, then as is provided in section 113 (a) (9) of the Revenue Act of 1932, the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the new shares or securities shall be determined in accordance with the following rules:

(1) If the stock distributed in reorganization consists solely of stock in the distributing corporation and is all of substantially the same character and preference as the stock in respect of which the distribution is made, the basis of each share will be the quotient of the cost or other basis of the old shares of stock divided by the total number of the old and the new shares.

(2) If the stock distributed in reorganization is in whole or in part stock in a corporation a party to the reorganization other than the distributing corporation, or where the stock distributed in reorganization is in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists wholly or partly of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of the foregoing provisions, securities are different in class from stocks and stocks or securities in one corporation are different in class from stocks or securities in another corporation. In general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security so that different values may properly be assigned thereto, will constitute a difference in class.

(3) If the stock in respect of which a distribution in reorganization is made was purchased at different times or at different prices, and the identity of the lots cannot be determined, any sale of the original stock will be charged to the earliest purchases of such stock (see article 22 (a)-8), and any sale of the stock or securities distributed in reorganization will be presumed to have been made from the stock or securities distributed in respect of the earliest purchased stock.

(4) If the stock in respect of which a distribution in reorganization is made was purchased at different times or at different prices, and the stock or securities distributed in reorganization cannot be identified as having been distributed in respect of any particular lot of such stock, then any sale of the stock or securities distributed in reorganization will be presumed to have been made from the stock or securities distributed in respect of the earliest purchased stock.

If in any taxable year beginning after December 31, 1937, without the surrender of his stock there is acquired by a shareholder in a corporation a party to a reorganization, as a distribution in pursuance of the plan of reorganization, stock or securities in a corporation a party to the reorganization, such acquisition of new shares or securities by the shareholder will be treated as a dividend to the extent described in article 112 (g)-5.

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(13) *Partnerships.*—If the property was acquired, after February 28, 1913, by a partnership and the basis is not otherwise determined under any other paragraph of this subsection, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

ART. 113 (a) (13)-1. *Property contributed in kind by a partner to a partnership.*—The basis of property contributed in kind by a partner to partnership capital after February 28, 1913, is the cost or other basis thereof to the contributing partner. Annual allowances to the partnership for depletion and depreciation are to be computed on such basis. If such basis is greater than the fair market value of the property at the date of the transfer to the partnership, the annual depletion or depreciation allowances shall be allocated to and included in the determination of the distributive shares of the partners in accordance with their agreement in respect of the sharing of gains or losses affecting partnership capital. If the basis of such contributed property is less than the fair market value thereof at the date of transfer to the partnership, the annual allowances for depletion and depreciation are to be limited to such basis and may be apportioned among the partners according to their agreement with respect to the sharing of gains or losses affecting partnership capital. On the sale or other disposition of such contributed property by the partnership the gain or loss, determined on such transferred basis, adjusted as required by section 113 (b), shall be prorated in determining the distributive shares of the partners according to their gain or loss ratios on the disposition of a partnership asset under the partnership agreement.

ART. 113 (a) (13)-2. *Readjustment of partnership interests.*—When a partner retires from a partnership, or the partnership is dissolved, the partner realizes a gain or loss measured by the difference between the price received for his interest and the sum of the adjusted cost or other basis to him of his interest in the partnership plus the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid. However, if such interest in the partnership was acquired prior to March 1, 1913, both the cost or other basis as hereinbefore provided and the value of such interest as of such date, plus the amount of his share in any undistributed partnership net income earned since February 28, 1913, on which the income tax has been paid, shall be ascertained, and the gain derived or the loss sustained shall be computed as provided in article 111-1. See also section 117. If the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received in liquidation. The basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

If a new partner is admitted to the partnership, or an existing partnership is reorganized, the facts as to such change or reorganization should be fully set forth in the next return of income, in order that the Commissioner may determine whether any gain has been realized or loss sustained by any partner.

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(14) *Property acquired before March 1, 1913.*—In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection, adjusted (for the period prior to March 1, 1913) as provided in subsection (b), is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

ART. 113 (a) (14)-1. *Property acquired prior to March 1, 1913.*—The basis as of March 1, 1913, for determining gain in the case of property acquired prior to that date, is the basis otherwise provided for such property under section 113 (a), adjusted for the period prior to

March 1, 1913, or the fair market value of the property as fo March 1, 1913, whichever is higher.

The basis as of March 1, 1913, for determining loss in the case of property acquired prior to that date is the cost or other basis provided for such property under section 113 (a) adjusted as required by section 113 (b), but without reference to the fair market value of the property as of March 1, 1913.

Example: A, who makes his returns upon the calendar year basis, in 1908 purchased property for $100,000. Assuming, for the purposes of this example, that there are no additions and betterments to be taken into account, the depreciation sustained on the property prior to March 1, 1913, was $10,000, so that the original cost adjusted as of March 1, 1913, for depreciation sustained prior to that date was $90,000. As of that date the fair market value of the property was $94,000. (*a*) For the purpose of determining gain from the sale or other disposition of the property on March 1, 1938, the basis of the property is the fair market value of $94,000 as of March 1, 1913, adjusted for depreciation for the period subsequent to February 28, 1913, computed on such fair market value. If it be assumed that the amount of depreciation deductions allowed (not less than the amount allowable) after February 28, 1913, to the year 1938 is in the aggregate sum of $43,240, the adjusted basis for determining gain in 1938 ($94,000 less $43,240) is $50.760. (*b*) For the purpose of determining a loss from the sale or other disposition of such property in 1938, the basis of the property is the cost of the property, without reference to the fair market value as of March 1, 1913, adjusted for depreciation before March 1, 1913, and after February 28, 1913. The amount of depreciation sustained prior to March 1, 1913, in this example is $10,000, and if the amount of depreciation to be accounted for after February 28, 1913, is assumed to be $43,240, the aggregate amount of depreciation for which adjustment of such cost must be made is $53,240. The adjusted basis for determining the loss in 1938 ($100,000 less $53,240) is $46,760.

What the fair market value of property was on March 1, 1913, is a question of fact to be established by competent evidence. In determining the fair market value of stock in a corporation, due regard shall be given to the fair market value of the corporate assets on such date. In the case of property traded in on public exchanges, actual sales at or about the basic date afford evidence of value. In general, the fair market value of a block or aggregate of a particular kind of property is not to be determined by a forced sale price or by an estimate of what a whole block or aggregate would bring if placed upon the market at one and the same time, but such value should be determined by ascertaining as the basis the fair market value of each unit of the property. All relevant facts and elements of value as of the basic date should be considered in every case.

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(15) *Property received by a corporation on complete liquidation of another.*—If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112 (b) (6), then the basis shall be the same as it would be in the hands of the transferor. The basis of property with respect to which election has been made in pursuance of the last sentence of section 113 (a) (15) of the Revenue Act of 1936, as amended, shall, in the hands of the corporation making such election, be the basis prescribed in the Revenue Act of 1934, as amended.

ART. 113 (a) (15)-1. *Basis of property received by a corporation in complete liquidation of another corporation.*—Except as otherwise provided in this article, the basis of property received in complete liquidation, without the recognition of gain or loss as provided in section 112 (b) (6), shall be the same as the basis of the property in the hands of the liquidating corporation with proper adjustments as provided in section 113. See section 113 (b).

In the case of property received in liquidation after December 31, 1935, and before June 23, 1936, in a taxable year of the recipient corporation beginning after December 31, 1935, the basis of such property in the hands of the recipient corporation shall be the basis prescribed by section 113 (a) (6) of the Revenue Act of 1934, as amended by the Revenue Act of 1935, if—

(1) Such property was received in a liquidation which was completed before June 23, 1936;

(2) Such liquidation constituted a complete liquidation within the meaning of section 112 (b) (6) of the Revenue Act of 1934, as added by the Revenue Act of 1935;

(3) No gain or loss would have been recognized under section 112 (b) (6) of the Revenue Act of 1934, as amended, upon the receipt of such property; and

(4) The recipient corporation (within 180 days after the enactment of the Revenue Act of 1938) under regulations prescribed under section 808 elected to have such basis apply to such property.

If such an election was made, the basis of such property received in liquidation shall be the cost or other basis (adjusted as provided in section 113) of the stock of the liquidating corporation surrendered in exchange for the property, decreased in the amount of money received and increased in the amount of gain or decreased in the amount of loss to the recipient corporation that was recognized upon the liquidation under the Revenue Act of 1936. If such property consists of more than one class of property the basis shall be allocated among the several properties (other than money) received, in the proportion that the fair market value of each such property as of the date of distribution bears to the fair market value of all such properties on that date.

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(16) *Basis established by Revenue Act of 1934.*—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1936, and the basis thereof, for the purposes of the Revenue Act of 1934 was prescribed by section 113 (a) (6), (7), or (8) of such Act, then for the purposes of this Act the basis shall be the same as the basis therein prescribed in the Revenue Act of 1934.

ART. 113 (a) (16)-1. *Basis of property established by Revenue Act of 1934.*—Section 113 (a) (16) provides that if property was acquired after February 28, 1913, in any taxable year beginning prior to January 1, 1936, and the basis of the property for the purposes of the Revenue Act of 1934 was prescribed by section 113 (a) (6), (7), or (8) of that Act, then for the purposes of the Revenue Act of 1938 the basis shall be the same as the basis therein prescribed under the Revenue Act of 1934. For example, if after December 31, 1920, and in any taxable year beginning prior to January 1, 1936, property was acquired by a corporation by the issuance of its stock or securities in connection with a transaction which is not described in section 112 (b) (5) of the Act but which is described in section 112 (b) (5) of the Revenue Act of 1934, the basis of the property so acquired shall be the same as it would be in the hands of the transferor, with proper adjustments to the date of the exchange.

[SEC. 113. *Adjusted basis for determining gain or loss.*]

[(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—]

(17) *Property acquired in connection with exchanges and distributions in obedience to certain orders of Securities and Exchange Commission.*—If the property was acquired in any manner described in section 373, the basis shall be that prescribed in such section with respect to such property.

(18) *Property received in certain corporate liquidations.*—If the property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock with respect to which gain was realized, but with respect to which, as the result of an election made by him under paragraph (7) of section 112 (b), the extent to which gain was recognized was determined under such paragraph, then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by him, and increased in the amount of gain recognized to him.

ART. 113 (a) (18)-1. *Basis of property received in certain corporate liquidations.*—(*a*) *Property included.*—Section 113 (a) (18) applies only to property (other than money) acquired (1) by a qualified electing shareholder, (2) upon a distribution in complete liquidation of a domestic corporation pursuant to a plan of liquidation adopted after May 28, 1938, in accordance with which the distribution is in complete cancellation or redemption of all the stock and the transfer of all the property in the liquidation occurs within the month of December, 1938, and (3) in cancellation or redemption of only those shares of stock which were owned by such qualified electing shareholder on the date of the adoption of the plan of liquidation and on which he realizes gain. It applies to all the property, except money, so acquired, though such property may consist in whole or in part of stock or securities acquired by the liquidating corporation after April 9, 1938.

(*b*) *Basis.*—The basis of such property so acquired is the same as the basis of the shares of stock, in cancellation or redemption of which such property was received, with proper adjustments to the date of acquisition, decreased in the amount of such shares' ratable share of any money received in cancellation or redemption of shares of the same class, and increased in the amount of gain recognized under the provisions of section 112 (b) (7). If such property consists of more than one class of property, the basis shall be allocated among the several properties (other than money) acquired in the proportion that the fair market value of each such property as of the date of acquisition bears to the fair market value of all such properties on that date. The application of this paragraph may be illustrated by the following example:

Example: The X Corporation distributed all its property in complete liquidation during the month of December, 1938, pursuant to the provisions of section 112 (b) (7). A, an individual and a qualified electing shareholder, received, in cancellation or redemption of 100 shares of stock owned by him on the date of the adoption of the plan of liquidation, $1,000 in cash, property (other than stock or securities acquired by the corporation after April 9, 1938) with a fair market value of $12,000, and stock acquired by the liquidating corporation after April 9, 1938, with a fair market value of $4,000. The basis of the shares owned by A was $100 per share, or $10,000. A's ratable share of the earnings and profits of the X Corporation accumulated after February 28, 1913 (computed as provided in section 112 (b) (7)), was $2,500. His gain is $7,000, but under section 112 (b) (7) only $5,000 of this gain is recognized, $2,500 thereof being taxed as a dividend. The basis of all the property other than money received by A is $14,000, computed as follows:

Adjusted basis of stock canceled or redeemed	$10,000
Less money received	1,000
Remainder	9,000
Plus gain recognized	5,000
Basis of property acquired	14,000

This basis will be apportioned among the classes of property (other than money) received as follows: 12,000/16,000 of $14,000, or $10,500, to the property other than stock; 4,000/16,000 of $14,000, or $3,500, to the stock.

[SEC. 113. *Adjusted basis for determining gain or loss.*]

(*b*) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(C) in respect of any period prior to March 1, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

(D) in the case of stock (to the extent not provided for in the foregoing subparagraphs) for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation, which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921);

(E) to the extent provided in section 337 (f) in the case of the stock of United States shareholders in a foreign personal holding company; and

(F) to the extent provided in section 28 (h) in the case of amounts specified in a shareholder's consent made under section 28.

(2) *Substituted basis.*—The term "substituted basis" as used in this subsection means a basis determined under any provision of subsection (a) of this section or under any corresponding provision of a prior income tax law, providing that the basis shall be determined—

(A) by reference to the basis in the hands of a transferor, donor, or grantor, or

(B) by reference to other property held at any time by the person for whom the basis is to be determined.

Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, then the adjustments provided in paragraph (1) of this subsection shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. A similar rule shall be applied in the case of a series of substituted bases.

ART. 113 (b)-1. *Adjusted basis: General rule.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, is the cost of such property or, in the case of such property as is described in paragraphs (1) to (18), inclusive, of section 113 (a), the basis therein provided, adjusted to the extent provided in section 113 (b).

The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. In the case of mines and oil or gas wells the following shall not be considered as items properly chargeable to capital account: (1) Expenditures made in the taxable year 1932 or subsequent taxable years which are allowable under article 235 or article 236 of Regulations 77, article 23 (m)-15 or 23 (m)-16 of Regulations 86, article 23 (m)-15 or 23 (m)-16 of Regulations 94, and article 23 (m)-15 or 23 (m)-16 of these regulations as deductions in computing net income; (2) expenditures made in taxable years prior to 1932 which were allowed, or which may hereafter be allowed, as deductions in computing the net income of the taxpayer for such taxable years. In the case of unimproved and unproductive real property, carrying charges, such as taxes and interest, which have not been taken as deductions by the taxpayer in determining net income for the taxable year, or a prior taxable year, are properly chargeable to capital account.

Example: A, who makes his returns on the calendar year basis, purchased property in 1929 for $10,000. He subsequently expended $6,000 for improvements. Disregarding, for the purpose of this example, the adjustments required for depreciation, the adjusted basis of the property is $16,000. If A sells the property in 1938 for $20,000, the amount of his gain will be $4,000. As to the amount of such gain to be taken into account in computing net income, see section 117.

The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent such deductions have in respect of any period since February 28, 1913, been allowed (but such decrease shall not be less than the amount of deductions allowable) under the Revenue Act of 1938 or prior income tax laws. The adjustment required for any taxable year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto, whichever is the greater amount. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period. The aggregate sum of the greater of such annual amounts is the amount by which the cost or other basis of the property shall be adjusted. For example, the case of Corporation A discloses the following facts as of January 1, 1938:

Year	Allowed	Allowable	Allowed, but not less than amount allowable
1931	$6,000	$5,000	$6,000
1932	7,000	6,500	7,000
1933	6,500	6,500	6,500
1934	6,500	6,000	6,500
1935	5,000	6,000	6,000
1936	4,500	6,000	6,000
1937	4,000	6,000	6,000
	39,500	42,000	44,000

The depreciation allowed but not less than the amount allowable in this example as of January 1, 1938, is $44,000, and the cost or other basis of the property is to be adjusted by that amount. The deductions by which the cost or other basis is to be decreased shall include deductions allowed under section 114 (b) (2), (3), and (4) of the Revenue Act of 1932, the Revenue Act of 1934, the Revenue Act of 1936, and the Revenue Act of 1938, for the taxable year 1932 and subsequent taxable years, but the amount of the diminution in respect of depletion for taxable years prior to 1932 shall not exceed a depletion deduction computed without reference to discovery value in the case of mines, or without reference to discovery value or a percentage of income in the case of oil and gas wells.

The cost or other basis shall also be decreased by the exhaustion, wear and tear, obsolescence, amortization, and depletion sustained in respect of any period prior to March 1, 1913.

In the case of stock, the cost or other basis must be diminished by the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax free or were applicable in reduction of basis (not including distributions made by a corporation, which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921).

Example: A, who makes his returns upon the calendar year basis, purchased stock in 1923 for $5,000. He received in 1924 a distribution of $2,000 paid out of earnings and profits of the corporation accumulated prior to March 1, 1913. The adjusted basis for determining the gain or loss from the sale or other disposition of the stock in 1938 is $5,000 less $2,000, or $3,000, and the amount of the gain or loss from the sale or other disposition of the stock is the difference between $3,000 and the amount realized from the sale or other disposition. But see section 117.

In the case of the stock of United States shareholders in a foreign personal holding company the cost or other basis must be adjusted also to the extent provided in section 337 (f).

Adjustments must always be made to eliminate double deductions or their equivalent. Thus, in the case of the stock of a subsidiary company, the basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made.

In determining basis, and adjustments to basis, the principles of estoppel apply, as elsewhere under the Act.

ART. 113 (b)-2. *Adjusted basis: Cancellation of indebtedness.*—In addition to the adjustments provided in section 113 (b) (1) and article 113 (b)-1 which are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in any case in which there shall have been a cancellation or reduction of indebtedness in any proceeding under section 12, 74 (except in the case of a "wage earner" as defined in the Bankruptcy Act, as amended), or 77B or under Chapter X, XI, or XII of the Bankruptcy Act of 1898, as amended. (See page 665 of the Appendix to these regulations.) Such further adjustment shall be made in the following manner and order:

(1) In the case of indebtedness incurred to purchase specific property (other than inventory or notes or accounts receivable), whether or not a lien is placed against such property securing the payment of all or part of such indebtedness, which indebtedness shall have been canceled or reduced in any such proceeding, the cost or other basis of such property shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this article) by the amount by which the indebtedness so incurred with respect to such property shall have been canceled or reduced;

(2) In the case of specific property (other than inventory or notes or accounts receivable), against which, at the time of the cancellation or reduction of the indebtedness, there is a lien (other than a lien securing indebtedness incurred to purchase such property) the cost or other basis of such property shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this article) by the amount by which the indebtedness secured by such lien shall have been canceled or reduced;

(3) Any excess of the total amount by which the indebtedness shall have been so canceled or reduced in such proceeding over the sum of the adjustments made under (1) and (2) shall next be applied to reduce the cost or other basis of the property of the debtor (other than inventory and notes and accounts receivable, but including property covered by (1) and (2)) as follows: The cost or other basis of each unit of property shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this article) in an amount equal to such proportion of such excess as the adjusted basis (without reference to this article) of each such unit of property bears to the sum of the adjusted bases (without reference to this article) of all the property of the debtor other than inventory and notes and accounts receivable; and

(4) Any excess of the total amount by which such indebtedness shall have been so canceled or reduced over the sum of the adjustments made under (1), (2), and (3) shall next be applied to reduce the cost or other basis of inventory and notes and accounts receivable, as follows: The cost or other basis of inventory or notes or accounts receivable, as the case may be, shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this article) in an amount equal to such proportion of such excess as the adjusted basis of inventory, notes receivable or accounts receivable, as the case may be, bears to the sum of the adjusted bases of such inventory and notes and accounts receivable.

For the purposes of this article—

(A) Basis shall be determined as of the date of confirmation of the plan, composition or arrangement under which such indebtedness shall have been canceled or reduced;

(B) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(C) No adjustment shall be made by virtue of the cancelation or reduction of any accrued interest unpaid which shall not have resulted in a tax benefit in any income tax return; and

(D) The phrase "indebtedness incurred to purchase" includes (i) indebtedness for money borrowed and applied in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay.

The basis of any of the debtor's property which shall have been transferred to a person required to use the debtor's basis in whole or in part shall be determined in accordance with the provisions of this article.

ART. 113 (b)-3. *Substituted basis.*—Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 113 (b) (2), the adjustments indicated in article 113 (b)-1 shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. In addition, whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 113 (b) (2) (A), the adjustment indicated in article 113 (b)-2 shall also be made, whenever necessary, after first making in respect of such substituted basis a proper adjustment of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor. Similar rules shall also be applied in the case of a series of substituted bases.

Example: A, who makes his returns upon the calendar year basis, in 1926 purchased the X Building and subsequently gave it to his son B. B exchanged the X Building for the Y Building in a tax-free exchange, and then gave the Y Building to his wife C. C, in determining the gain from the sale or other disposition of the Y Building in 1938, is required to reduce the basis of the building by deductions for depreciation which were successively allowed (but not less than the amount allowable) to A and B upon the X Building and to B upon the Y Building, in addition to the deductions for depreciation allowed (but not less than the amount allowable) to herself during her ownership of the Y Building.

CHAPTER XIV

Depreciation and Depletion

SEC. 114. *Basis for depreciation and depletion.*—(a) *Basis for depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

(b) *Basis for depletion.*— (1) *General rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

(2) *Discovery value in case of mines.*—In the case of mines (other than metal, coal, or sulphur mines) discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance under section 23 (m) based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit.

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

(4) *Percentage depletion for coal and metal mines and sulphur.*—The allowance for depletion under section 23 (m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, 15 per centum, and, in the case of sulphur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property. A taxpayer making his first return under this title in respect of a property shall state whether he elects to have the depletion allowance for such property for the taxable year for which the return is made computed with or without regard to percentage depletion, and the depletion allowance in respect of such property for such year shall be computed according to the election thus made. If the taxpayer fails to make such statement in the return, the depletion allowance for such property for such year shall be computed without reference to percentage depletion. The method, determined as above, of computing the depletion allowance shall be applied in the case of the property for all taxable years in which it is in the hands of such taxpayer, or of any other person if the basis of the property (for determining gain) in his hands is, under section 113, determined by reference to the basis in the hands of such taxpayer, either directly or through one or more substituted bases, as defined in that section. The above right of election shall be subject to the qualification that this paragraph shall, for the purpose of determining whether the method of computing the depletion allowance follows the property, be considered a continuation of section 114 (b) (4) of the Revenue Act of 1934 and the Revenue Act of 1936, and as giving no new election in cases where either of such sections would, if applied, give no new election.

ART. 114-1. *Basis for allowance of depreciation and depletion.*—The basis upon which exhaustion, wear and tear, obsolescence, and depletion will be allowed in respect of any property is the same as is provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain from the sale or other disposition of such property, except as provided in article 23 (m)-3, relating to depletion based on discovery value, in article 23 (m)-4, relating to percentage depletion in the case of oil and gas wells, and in article 23 (m)-5, relating to percentage depletion in the case of coal mines, metal mines, and sulphur mines or deposits.

CHAPTER XV

Distributions by Corporations—Dividends

SEC. 115. *Distributions by corporations.*—(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding, from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years, if the first of such series of distributions is made in a taxable year beginning after December 31, 1937, or (2) two years, if the first of such series of distributions was made in a taxable year beginning before January 1, 1938. In the case of amounts distributed (whether before January 1, 1938, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. If any distribution in complete liquidation (including any one of a series of distributions made by the corporation in complete cancellation or redemption of all its stock) is made by a foreign corporation which with respect to any taxable year beginning on or before, and ending after, August 26, 1937, was a foreign personal holding company, and with respect to which a United States group (as defined in section 331 (a) (2)) existed after August 26, 1937, and before January 1, 1938, then, despite the foregoing provisions of this subsection, the gain recognized resulting from such distribution shall be considered as a short-term capital gain—

(1) Unless such liquidation is completed before July 1 1938; or

(2) Unless (if it is established to the satisfaction of the Commissioner by evidence submitted before July 1, 1938, that due to the laws of the foreign country in which such corporation is incorporated, or for other reason, it is or will be impossible to complete

the liquidation of such company before such date) the liquidation is completed on or before such date as the Commissioner may find reasonable, but not later than December 31, 1938.

(d) *Other distributions from capital.*—If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

(e) *Distributions by personal service corporations.*—Any distribution made by a corporation, which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or the Revenue Act of 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or section 218 of the Revenue Act of 1921, shall be exempt from tax to the distributees.

(f) *Stock dividends.*—(1) *General rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(2) *Election of shareholders as to medium of payment.*—Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

(g) *Redemption of stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1938, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

(i) *Definition of partial liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

(j) *Valuation of dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

(k) *Consent distributions.*—For taxability as dividends of amounts agreed to be included in gross income by shareholders' consents, see section 28.

ART. 115-1. *Dividends.*—The term "dividend" for the purpose of Title I (except when used in sections 203 (a) (3) and 207 (c) (1) thereof) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings or profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.

The application of section 115 (a) may be illustrated by the following example:

Example: At the beginning of the calendar year 1938, the M Corporation had an operating deficit of $200,000 and the earnings or profits for the year amounted to $100,000. Beginning on March 16, 1938, the corporation made quarterly distributions during the taxable year to its shareholders of $25,000 each. Each distribution is a taxable dividend in full, irrespective of the actual or the pro rata amount of the earnings or profits on hand at any of the dates of distribution, since the total distributions made during the year ($100,000) did not exceed the total earnings or profits of the year ($100,000).

ART. 115-2. *Sources of distributions in general.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. In determining the source of a distribution, consideration should be given *first*, to the earnings or profits of the taxable year; *second*, to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; *third*, to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and, *fourth*, to sources other than earnings or profits only after the earnings or profits have been distributed.

If the earnings or profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings or profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. (See article 115-1.) If the distributions made during the taxable year exceed the earnings or profits of such year, then that proportion of each distribution which the total of the earnings or profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings or profits of that year. The portion of each such distribution which is not regarded as out of earnings or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings or profits accumulated since February 28, 1913, and the actual earnings or profits to the date of a distribution within any taxable year (whether beginning before January 1, 1938, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made. The provisions of this article may be illustrated by the following example:

Example: At the beginning of the calendar year 1938, the M Corporation had $12,000 in earnings and profits accumulated since February 28, 1913. Its earnings and profits for 1938 amounted to $30,000. During the year it made quarterly distributions of $15,000 each. Of each of the four distributions made, $7,500 (that portion of $15,000 which the amount of $30,000, the total earnings and profits of the taxable year, bears to $60,000, the total distributions made during the year) was paid out of the earnings and profits of the taxable year; and of the first and second distributions, $7,500 and $4,500, respectively, were paid out of the earnings and profits accumulated after February 28, 1913, and prior to the taxable year, as follows:

Distributions during 1938				
Date	Amount	Portion out of earnings or profits of the taxable year	Portion out of earnings accumulated since Feb. 28, 1913, and prior to taxable year	Taxable amount of each distribution
Mar. 10	$15,000	$7,500	$7,500	$15,000
June 10	15,000	7,500	4,500	12,000
Sept. 10	15,000	7,500		7,500
Dec. 10	15,000	7,500		7,500
Total amount taxable as dividends				42,000

Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase in value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether prior to or on or after March 1, 1913), is not a dividend within the meaning of Title I.

ART. 115-3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

In the case of a corporation in which depletion is a factor in the determination of income, the only depletion deductions to be considered in the computation of earnings or profits are those based on (1) cost or other basis, if the depletable asset was acquired subsequent to February 28, 1913, or (2) adjusted cost or March 1, 1913, value, whichever is higher, if acquired prior to March 1, 1913. Thus, discovery and percentage depletion under all Revenue Acts for mines and oil and gas wells should not be taken into consideration in computing the earnings or profits of a corporation.

A loss sustained for a year prior to the taxable year does not affect the earnings or profits of the taxable year. However, in determining the earnings or profits accumulated since February 28, 1913, the excess of a loss sustained for a year subsequent to February 28, 1913, over the undistributed earnings or profits accumulated since February 28, 1913, and prior to the year for which the loss was sustained, reduces surplus as of March 1, 1913, to the extent of such excess. And, if the surplus as of March 1, 1913, was sufficient to absorb such excess, distributions to shareholders after the year of the loss are out of earnings or profits accumulated since the year of the loss to the extent of such earnings.

With respect to the effect on the earnings or profits accumulated since February 28, 1913, of distributions made on or after January 1, 1916, and prior to August 6, 1917, out of earnings or profits accumulated prior to March 1, 1913, which distributions were specifically declared to be out of earnings or profits accumulated prior to March 1, 1913, see section 31 (b) of the Revenue Act of 1916, as amended by section 1211 of the Revenue Act of 1917.

ART. 115-4. *Distributions other than a dividend.*—Under section 115 (d), any distribution (including a distribution out of earnings or profits accumulated before March 1, 1913) other than

(1) a dividend (see articles 115-1 and 115-2),

(2) a distribution out of increase in value of property accrued prior to March 1, 1913 (see article III-1), or

(3) a distribution in partial or complete liquidation (see article 115-5)

shall be applied against and reduce the adjusted basis of the stock provided in section 113 and shall be taxable to the recipient if, and to the extent that, such distribution exceeds such basis. The provisions of this article are applicable to such distributions received by one corporation from another corporation.

Example: In 1938 the M Corporation purchased certain shares of stock in the O Corporation for $10,000. During that year the M Corporation received a distribution from the O Corporation of $2,000 paid out of earnings or profits of the O Corporation accumulated prior to March 1, 1913. This distribution must be applied by the M Corporation against the basis of its stock in the O Corporation reducing such basis to $8,000. The $2,000 does not constitute a part of the earnings or profits of the M Corporation. If the M Corporation subsequently sells the stock of the O Corporation for $9,000, it realizes a gain of $1,000, which constitutes a part of its earnings or profits for the year in which the stock is sold. If the distribution had amounted to $14,000, the gain of $4,000 would be taxable to the M Corporation and would have constituted a part of the earnings or profits of that corporation for the year in which the distribution was made.

ART. 115-5. *Distributions in liquidation*—(a) *General.*—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so canceled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and article 111-1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112.

(b) *Complete liquidation.*—In the case of amounts distributed in complete liquidation of a corporation, the amount of the gain or loss so recognized is subject in general to the limitations contained in section 117. For this purpose the term "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding, from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years if the first of such series of distributions is made in a taxable year beginning after December 31, 1937, or (2) two years, if the first of such series of distributions was made in a taxable year beginning prior to January 1, 1938.

For the purposes of the last sentence of section 115 (c), a liquidation may be completed prior to the actual dissolution of the liquidating corporation but no liquidation is completed until the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible).

For the purpose of this article the determination of whether a foreign corporation was a foreign personal holding company with respect to a taxable year beginning on or before, and ending after August 26, 1937, shall be made under section 331 of the Revenue Act of 1936, added to such Act by section 201 of the Revenue Act of 1937, and articles 331-1, 331-2, and 331-3 of Chapter XXXIV, added to Regulations 94 by Treasury Decision 4782, approved December 7, 1937 (C. B. 1937-2, p. 163).

Example: A, an individual whose taxable year is the calendar year, owns 20 shares of stock of the N Corporation, a domestic corporation, 10 shares of which were acquired in 1924 at a cost of $1,250 and the balance of 10 shares in June

1936, at a cost of $3,000. He receives in May, 1938, a distribution of $200 per share in complete liquidation, or $2,000 on the 10 shares acquired in 1924, and $2,000 on the 10 shares acquired in June, 1936. The gain of $750 on the shares acquired in 1924 should be included in A's gross income to the extent of 50 percent, or $375; the loss of $1,000 on the shares acquired in 1936 should be deducted in computing A's net income to the extent of 66⅔ percent, or $666.67. (See section 117 (b). See also section 117 (c).)

(c) *Partial liquidation.*—In the case of amounts distributed in partial liquidation of a corporation, the amount of the loss recognized is subject to the limitations contained in section 117 but the entire amount of the gain recognized shall be considered as a short-term capital gain despite the provisions of section 117. The term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. A complete cancellation or redemption of a part of the corporate stock may be accomplished, for example, by the complete retirement of all the shares of a particular preference or series, or by taking up all the old shares of a particular preference or series and issuing new shares to replace a portion thereof, or by the complete retirement of any part of the stock, whether or not pro rata among the shareholders.

In the case of amounts distributed in partial liquidation, the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of section 115 (b) for the purpose of determining taxability of subsequent distributions by the corporation. (See articles 27 (g)-1 and 115-11.)

Example: A, an individual whose taxable year is the calendar year, owns 20 shares of participating preferred stock of the Y Corporation, 10 shares of which he purchased in 1924 for $1,060 and 10 shares of which he purchased in June, 1936, at $2,000. On May 15, 1938, the corporation in a transaction qualifying as a partial liquidation redeemed the entire issue of preferred stock by paying the holders thereof $141 per share. A receiving $2,820 upon the surrender of his 20 shares of such stock. The gain of $350 on the shares acquired in 1924 should be included in its entirety in A's gross income; but the loss of $590 on the shares acquired in 1936 should be deducted in computing A's net income to the extent of 66⅔ percent, or $393.33. (See section 117 (b). See also section 117 (c).)

ART. 115-6. *Distributions from depletion or depreciation reserves.*—A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets on account of depletion or depreciation is not a part of surplus out of which ordinary dividends may be paid. A distribution made from a depletion or a depreciation reserve based upon the cost or other basis of the property will not be considered as having been paid out of earnings or profits, but the amount thereof shall be applied against and reduce the cost or other basis of the stock upon which declared. If such a distribution is in excess of the basis, the excess shall be taxed as a gain from the sale or other disposition of property as provided in article 111-1. A distribution from a depletion reserve based upon discovery value to the extent that such reserve represents the excess of the discovery value over the cost or other basis for determining gain or loss, is, when received by the shareholders, taxable as an ordinary dividend. The amount by which a corporation's percentage depletion allowance for any year exceeds depletion sustained on cost or other basis, that is, determined without regard to discovery or percentage depletion allowances for the year of distribution or prior years, constitutes a part of the corporation's "earnings or profits accumulated after February 28, 1913," within the meaning of section 115, and, upon distribution to shareholders, is taxable to them as a dividend. A distribution made from that portion of a depletion reserve based upon a valuation as of March 1, 1913, which is in excess of the depletion reserve based upon cost, will not be considered as having been paid out of earnings or profits, but the amount of the distribution shall be applied against and reduce the cost or other basis of the stock upon which declared. (See article 111-1.) No distribution, however, can be made from such a reserve until all the earnings or profits of the corporation have first been distributed.

ART. 115-7. *Stock dividends.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. The Supreme Court has pointed out some of the characteristics distinguishing a stock dividend which constitutes income from one which does not constitute income within the meaning of the Constitution.[1] The distinction between a stock dividend which does not, and one which does, constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution is the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus the old representing the same proportionate interest in the net assets of the corporation as did the old.

Example (1): The X Corporation had an authorized capital stock of $300,000 of common stock, par value $10 a share, and $100,000 of 7 percent cumulative preferred stock, par value $100 a share, which is preferred as to dividends, has no voting rights, and may be redeemed at any time at $105 per share. The articles of incorporation provide that the annual dividend on the preferred stock may be paid in cash or, at the option of the corporation, in one share of common stock for each share of preferred. On July 1, 1938, the X Corporation had outstanding $200,000 of common stock and $100,000 of preferred stock, earnings and profits of $60,000 accumulated since February 28, 1913, and earnings and profits of the taxable year amounting to $15,000. On July 1, 1938, it distributed 1,000 shares of its common stock of an aggregate par value (and fair market value) of $10,000 to the holders of its preferred stock in payment of the annual dividend on such stock. The stock so distributed constitutes a taxable stock dividend to the holders of the preferred stock.

Example (2): On July 1, 1938, the Y Corporation had an authorized capital stock consisting of 1,000 shares of common stock, par value $100 a share, of which 500 shares were outstanding. It had earnings and profits of $40,000 accumulated since February 28, 1913, and $5,000 of earnings and profits of the taxable year. On July 1, 1938, the Y Corporation issued and divided among its shareholders 250 additional shares of its common stock of a total par value of $25,000 and transferred an equivalent amount from surplus account to capital stock account. The stock so distributed does not constitute a taxable stock dividend to the shareholders.

Example (3): The Z Corporation had an authorized capital stock of 30,000 shares of common, without par value, and 10,000 shares of 7 percent cumula-

[1] See *Eisner* v. *Macomber* (252 U. S., 189, T. D. 3010, C. B. 3, 25 (1920)); and *Koshland* v. *Helvering* (298 U. S., 441, Ct. D. 1124, C. B. VX-1, 219 (1936)). Compare *United States* v. *Phellis* (257 U. S., 156, T. D. 3270, C. B. 5, 37 (1921)); *Rockefeller* v. *United States* (257 U. S., 176, T. D. 3271, C. B. 5, 34 (1921)); *Cullinan* v. *Walker* (262 U. S., 134, T. D. 3508, C. B. II-2, 55 (1923)); *Weiss* v. *Stearn* (265 U. S., 242, T. D. 2609, C. B. III-2, 51 (1924)); and *Marr* v. *United States* (268 U. S., 536, T. D. 3755, C. B. IV-2, 116 (1925)).

tive preferred stock, par $100, which is preferred as to dividends, has voting rights and may be redeemed on the 1st of January or July of any year by the payment of $105 per share and accrued dividends. On July 1, 1938, the company's issued and outstanding stock amounted to 20,000 shares of common and 6,000 shares of preferred, and it had $250,000 earnings and profits accumulated since February 28, 1913, and $90,000 earnings and profits of the taxable year. On July 1, 1938, it paid a dividend on its common stock in preferred stock at the rate of $\frac{1}{10}$ share of preferred on each share of common outstanding. The preferred stock so distributed constitutes a taxable stock dividend to the holders of common stock.

ART. 115-8. *Election of shareholders as to medium of payment.*—If the shareholder has the right to an election or option with respect to whether a distribution shall be paid either (*a*) in money or any other property or (*b*) in stock or rights to acquire stock of a class which, if distributed without an election, would not constitute income within the meaning of the sixteenth amendment to the Constitution, then the entire distribution is a taxable dividend regardless of—

(1) whether the distribution is actually made, in whole or in part, in stock or in stock rights which, if distributed without election, would not constitute a taxable dividend;

(2) whether the election is exercised or exercisable before or after the declaration of the distribution; or

(3) whether the declaration of the dividend provides that payment will be made in one medium unless the shareholder specifically requests payment in the other.

The term "any other property" as used in this article includes stock of the corporation or rights to acquire its stock, of a class which if distributed without an election, would constitute income within the meaning of the sixteenth amendment to the Constitution. (See article 115-7.)

ART. 115-9. *Distribution in redemption or cancellation of stock taxable as a dividend.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

ART. 115-10. *Dividends paid in property.*—If the whole or any part of the dividend is paid to a shareholder in any medium other than money, the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder. (See article 42-3.) Scrip dividends are subject to tax in the year in which the warrants are issued.

ART. 115-11. *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1938, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1938, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in section 112 (b) (6) of the Revenue Act of 1936 or section 112 (b) (6) of the Revenue Act of 1938.

(3) The distribution in any taxable year (beginning after December 31, 1937) of stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

For the purposes of this article, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932; for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934; and for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936.

CHAPTER XVI

Additional Exclusions From Gross Income

SEC. 116. *Exclusions from gross income.*—In addition to the items specified in section 22 (b), the following items shall not be included in gross income and shall be exempt from taxation under this title:

(a) *Earned income from sources without United States.*—In the case of an individual citizen of the United States, a bona fide nonresident of the United States for more than six months during the taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts would constitute earned income as defined in section 25 (a) if received from sources within the United States; but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this subsection.

(b) *Teachers in Alaska and Hawaii.*—In the case of an individual employed by Alaska or Hawaii or any political subdivision thereof as a teacher in any educational institution, the compensation received as such. This subsection shall not exempt compensation paid directly or indirectly by the Government of the United States.

(c) *Income of foreign governments.*—The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States.

(d) *Income of States, municipalities, etc.*—Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof.

Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility—

(1) If by the terms of such contract the tax imposed by this title is to be paid out of the proceeds from the operation of such public utility, prior to any division of such proceeds between the person and the State, Territory, political subdivision, or the District of Columbia, and if, but for the imposition of the tax imposed by this title, a part of such proceeds for the taxable year would accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, then a tax upon the net income from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this title, but there shall be refunded to such State, Territory, political subdivision, or the District of Columbia (under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary) an amount which bears the same relation to the amount of the tax as the amount which (but for the imposition of the tax imposed by this title) would have accrued directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, bears to the amount of the net income from the operation of such public utility for such taxable year.

(2) If by the terms of such contract no part of the proceeds from the operation of the public utility for the taxable year would, irrespective of the tax imposed by this title, accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, then the tax upon the net income of such person from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this title.

(e) *Bridges to be acquired by State or political subdivision.*—Whenever any State or political subdivision thereof, in pursuance of a contract to which it is not a party entered into before the enactment of the Revenue Act of 1928, is to acquire a bridge—

(1) If by the terms of such contract the tax imposed by this title is to be paid out of the proceeds from the operation of such bridge prior to any division of such proceeds, and if, but for the imposition of the tax imposed by this title, a part of such proceeds for the taxable year would accrue directly to or for the use of or would be applied for the benefit of such State or political subdivision, then a tax upon the net income from the operation of such bridge shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this title, but there shall be refunded to such State or political subdivision (under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary) an amount which bears the same relation to the amount of the tax as the amount which (but for the imposition of the tax imposed by this title) would have accrued directly to or for the use of or would be applied for the benefit of such State or political subdivision, bears to the amount of the net income from the operation of such bridge for such taxable year. No such refund shall be made unless the entire amount of the refund is to be applied in part payment for the acquisition of such bridge.

(2) If by the terms of such contract no part of the proceeds from the operation of the bridge for the taxable year would, irrespective of the tax imposed by this title, accrue directly to or for the use of or be applied for the benefit of such State or political subdivision, then the tax upon the net income from the operation of such bridge shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this title.

(f) *Dividend from "China Trade Act" corporation.*—In the case of a persons, amounts distributed as dividends to or for his benefit by a corporation organized under the China Trade Act, 1922, if, at the time of such distribution, he is a resident of China, and the equitable right to the income of the shares of stock of the corporation is in good faith vested in him.

(g) *Shipowners' protection and indemnity associations.*—The receipts of shipowners' mutual protection and indemnity associations not organized for profit, and no part of the net earnings of which inures to the benefit of any private shareholder; but such corporations shall be subject as other persons to the tax upon their net income from interest, dividends, and rents.

(h) *Compensation of employees of foreign governments.*—(1) *Rule for exclusion.*—Wages, fees, or salary of an employee of a foreign government (including a consular or other officer, or a nondiplomatic representative) received as compensation for official services to such government—

(A) If such employee is not a citizen of the United States; and

(B) If the services are of a character similar to those performed by employees of the Government of the United States in foreign countries; and

(C) If the foreign government whose employee is claiming exemption grants an equivalent exemption to employees of the Government of the United States performing similar services in such foreign country.

(2) *Certificate by Secretary of State.*—The Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries.

ART. 116-1. *Income of foreign governments, ambassadors, and consuls.*—The exemption of the income of foreign governments applies also to their political subdivisions. Any income collected by foreign governments from investments in the United States in stocks, bonds, or other domestic securities, which are not actually owned by but are loaned to such foreign governments, is subject to tax.

Ambassadors and ministers accredited to the United States and the members of their households (including secretaries, attachés, and servants) who are not citizens of the United States, are exempt from the payment of Federal income tax upon their salaries, fees, or wages. Their income from all sources other than a business carried on by them in the United States is also exempt. These provisions are also applicable to the wives and minor children of foreign ambassadors and ministers and the members of their households, including secretaries, attachés, and servants.

All employees of a foreign government (including consular or other officers, or nondiplomatic representatives) who are not citizens of the United States are exempt from Federal income tax with respect to wages, fees, or salaries received by them as compensation for official services rendered in the United States to such foreign government, provided (1) the services are of a character similar to those performed by employees of the Government of the United States in such foreign country and (2) the foreign government whose employees are claiming exemption grants an equivalent exemption to employees of the Government of the United States performing similar services in such foreign country. Section 116 (h) (2) provides that the Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries. The income received by employees of foreign governments (other than ambassadors, ministers and members of their households including secretaries, attachés and servants) from sources other than their salaries, fees, or wages, referred to above, is subject to Federal income tax. The compensation of citizens of the United States who are officers or employees of a foreign government is not exempt from income tax. (But see section 116 (a).) Under the provisions of the tax convention between the United States and France, and without regard to any other provision of this article, compensation paid by France to French citizens for labor or personal services performed in the United States is exempt from Federal income tax. (See page 680 of the Appendix to these regulations.)

ART. 116-2. *Compensation of State officers and employees.*—Compensation received for services rendered to a State is to be included in gross income unless the person receives such compensation from the State as an officer or employee thereof and such compensation is immune from taxation under the Constitution of the United States.

One is not an officer or employee of a State merely by reason of rendering services to the State and receiving compensation therefor. Persons employed by a State, under a contract for the rendering of services of a special nature, such as those performed by a consulting engineer who is employed to advise a State with respect to water supply or sewage disposal systems, whose duties are prescribed by the contract and whose work is not of a permanent or continuous character, are not officers or employees of the State.

If all or part of the compensation of an officer or employee of a State is paid directly or indirectly by the United States, such compensation (or part) is taxable, as, for example, any compensation paid by the United States to officers of the National Guard of a State, or compensation paid by a State to officers or employees of an agricultural school or college wholly or partly out of grants from the United States.

The commissions of receivers appointed by the State courts and the fees received by notaries public are taxable. As used in this article, the term "State" includes a political subdivision of a State.

ART. 116-3. *Bridges to be acquired by State or political subdivisions.*—(1) Any State or political subdivision thereof claiming a refund under the provisions of section 116 (e) of an amount equal to all or a portion of any income tax levied, assessed, collected, and paid in the manner and at the rates prescribed in Title I, shall file a claim therefor on Form 843 (to which there shall be attached as exhibits the matter hereinafter prescribed) with the collector of internal revenue for the district in which the tax was paid, which claim shall be executed on behalf of such State or political subdivision thereof by the treasurer or other fiscal officer thereof and shall contain—

(*a*) A statement of the name of the taxpayer, of the amount of tax levied, assessed, collected, and paid for the taxable year or period in respect of which the claim is made, and the amount of refund thereby sought;

(*b*) A full statement of the facts considered by the claimant sufficient to entitle it to the refund, including copies of all contracts and other documents bearing on the case, and a statement that the claim is submitted under the provisions of section 116 (e);

(*c*) A showing which will establish to the satisfaction of the Commissioner that the fiscal officer presenting the claim has authority to receive the amount of the refund on behalf of the State or political subdivision which he assumes to represent and to apply without delay the entire amount of such refund in part payment for the acquisition of such bridge, including copies of the laws, ordinances, or similar enactments considered by the claimant sufficient to establish its authority to receive the refund and so to apply it, together with a statement that such fiscal officer will receive and immediately so apply the entire amount of the refund; and

(*d*) An affidavit made by or on behalf of the taxpayer, which affidavit shall state that the taxpayer thereby joins with and concurs in the request of the State or political subdivision thereof that a refund of an amount equal to all or a portion of the tax previously paid by such taxpayer be made to such State or political subdivision, that the taxpayer agrees to receive the amount refunded from the State or political subdivision to which it is paid and immediately to apply the entire amount of such refund in part payment for the acquisition of such bridge, and that if for any reason the contract which is the basis of the claim for refund is not fully executed and performed, the taxpayer will repay to the United States upon its demand the entire amount of the refund with interest at 6 percent per annum from the date the refund is made without seeking or claiming the benefit of any statute of limitations which prior thereto may have run against the United States.

(2) No refund shall be made of any amount in excess of the amount of the tax levied, assessed, collected, and paid by the taxpayer for any taxable year or period. A separate claim shall be made in respect of each separate taxable year or period. If by the terms of the contract on which the claim is based two or more States or political subdivisions of a State or States are entitled to acquire the bridge, the claim for refund in respect of each separate taxable year or period must be made jointly by the States or political subdivisions thereof so entitled. The amount refunded under section 116 (e) and this article is not considered an overpayment within the meaning of section 614 of the Revenue Act of 1928 (paragraph 42 of the Appendix to these regulations), relating to interest on overpayments, and no interest shall be allowed or paid upon the amount of the refund.

(3) A check or voucher in payment of a claim for refund allowed under section 116 (e) will be drawn in the name of the fiscal officer or officers having authority, as established under paragraph (1) (*c*) hereof, to receive the same, and will contain an express provision that it is issued for the sole purpose and subject to the conditions prescribed in that section and this article.

CHAPTER XVII

Capital Gains and Losses

SEC. 117. *Capital gains and losses.*—(*a*) *Definitions.*—As used in this title—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l);

(2) *Short-term capital gain.*—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such gain is taken into account in computing net income;

(3) *Short-term capital loss.*—The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such loss is taken into account in computing net income;

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

(5) *Long-term capital loss.*—The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such loss is taken into account in computing net income;

(6) *Net short-term capital gain.*—The term "net short-term capital gain" means the excess of short-term capital gains for the taxable year over the sum of (A) short-term capital losses for the taxable year, plus (B) the net short-term capital loss of the preceding taxable year, to the extent brought forward to the taxable year under subsection (e);

(7) *Net short-term capital loss.*—The term "net short-term capital loss" means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year;

(8) *Net long-term capital gain.*—The term "net long-term capital gain" means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year;

(9) *Net long-term capital loss.*—The term "net long-term capital loss" means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

(*b*) *Percentage taken into account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

(c) *Alternative taxes.*—(1) *In case of net long-term capital gain.*—If for any taxable year a taxpayer (other than a corporation) derives a net long-term capital gain, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of the net long-term capital gain, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 30 per centum of the net long-term capital gain.

(2) *In case of net long-term capital loss.*—If for any taxable year a taxpayer (other than a corporation) sustains a net long-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is greater than the tax imposed by such sections:

A partial tax shall first be computed upon the net income increased by the amount of the net long-term capital loss, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax minus 30 per centum of the net long-term capital loss.

(d) *Limitation on capital losses.*—(1) *Corporations.*—In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. If a bank or trust company incorporated under the laws of the United States (including laws relating to the District of Columbia) or of any State or Territory, a substantial part of whose business is the receipt of deposits, sells any bond, debenture, note, or certificate or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, any loss resulting from such sale (except such portion of the loss as does not exceed the amount, if any, by which the adjusted basis of such instrument exceeds the par or face value thereof) shall not be subject to the foregoing limitation and shall not be included in determining the applicability of such limitation to other losses.

(2) *Other taxpayers.*—In the case of a taxpayer other than a corporation, short-term capital losses shall be allowed only to the extent of short-term capital gains.

(e) *Net short-term capital loss carry-over.*—If any taxpayer (other than a corporation) sustains in any taxable year a net short-term capital loss, such loss (in an amount not in excess of the net income for such year) shall be treated in the succeeding taxable year as a short-term capital loss, except that it shall not be included in computing the net short-term capital loss for such year.

(f) *Retirement of bonds, etc.*—For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

(g) *Gains and losses from short sales, etc.*—For the purpose of this title—

(1) gains or losses from short sales of property shall be considered as gains or losses from sales or exchanges of capital assets; and

(2) gains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as short-term capital gains or losses.

(h) *Determination of period for which held.*—For the purpose of this section—

(1) In determining the period for which the taxpayer has held property received on an exchange there shall be included the period for which he held the property exchanged, if under the provisions of section 113, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged.

(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

(3) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain was recognized to the distributee under the provisions of section 112 (g) of the Revenue Act of 1928 or the Revenue Act of 1932, or under the provisions of section 371 (c) of this Act, there shall be included the period for which he held the stock or securities in the distributing corporation prior to the receipt of the stock or securities upon such distribution.

(4) In determining the period for which the taxpayer has held stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 118 of this Act or section 118 of the Revenue Act of 1928 or the Revenue Act of 1932 or the Revenue Act of 1934 or the Revenue Act of 1936, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, there shall be included the period for which he held the stock or securities the loss from the sale or other disposition of which was not deductible.

ART. 117-1. *Meaning of terms.*—The term "capital assets" includes all classes of property not specifically excluded by section 117 (a) (1). In determining whether property is a "capital asset," the period for which held is immaterial.

The exclusion from the term "capital assets" of property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 23 (l) is limited to property used by the taxpayer in the trade or business at the time of the sale or exchange. It has no application to gains or losses arising from the sale of real property used in the trade or business to the extent that such gain or loss is allocable to the land, as distinguished from depreciable improvements upon the land. To such gain or loss allocable to the land the limitations of sections 117 (b), (c), and (d) apply (such limitation may be inapplicable to a dealer in real estate, but, if so, it is because he holds the land primarily for sale to customers in the ordinary course of his trade or business, not because land is subject to a depreciation allowance). Gains or losses from the sale or exchange of property used in the trade or business of the taxpayer of a character which is subject to the allowance for depreciation provided in section 23 (l), will not be subject to the percentage provisions of section 117 (b) and losses from such transactions will not be subject to the limitations on losses provided in section 117 (d). The term "ordinary net income" as used in these regulations for the purposes of section 117 means net income exclusive of gains and losses from the sale or exchange of capital assets.

Section 117 (a) (2) to (9), inclusive, defines "short-term capital gain," "short-term capital loss," "long-term capital gain," long-term capital loss," "net short-term capital gain," "net short-term capital loss," "net long-term capital gain," and "net long-term capital loss." These terms are used in the subsequent subsections of section 117. The phrase "short-term" applies to the category of gains and losses arising from the sale or exchange of capital assets held for 18 months or less; the phrase "long-term" to the category of gains and losses arising from the sale or exchange of capital assets held for more than 18 months. The fact that some part of a short-term capital loss may be finally disallowed because of the operation of section 117 (d) (2) does not mean that such loss is not "taken into account in computing net income" within the meaning of that phrase as used in section 117 (a) (3).

In the definition of "net short-term capital gain," as provided in section 117 (a) (6), reference is made in clause (B) thereof, to the net short-term capital loss of the preceding taxable year to the extent brought forward to the taxable year under subsection (e). The amount so provided for is the net short-term capital loss carry-over, which is treated in the taxable year in question as a short-term capital loss. In this computation, the carry-over enters into the computation of the net short-term capital gain only in clause (B). The amount thereof is not to be included under clause (A) of section 117 (a) (6). Thus, for the purposes of clause (A), the short-term capital losses for the taxable year are computed without reference to, or including, the amount provided for in subsection (e). For example, during the taxable year 1939 an individual has a short-term capital gain of $10,000 and a short-term capital loss in that year of $4,000. During the taxable year 1938 he sustained a net short-term capital loss of $2,500 which was not in excess of his net income for that year. His net short-term capital gain for the taxable year 1939 is computed as follows:

1939 short-term capital gain		$10,000
Less:		
1939 short-term capital loss to be allowed under section 117 (a) (6) (A)	$4,000	
Net short-term capital loss of proceeding taxable year to extent brought forward under section 117 (e) and allowed under section 117 (a) (6) (B)	2,500	
		6,500
Net short-term capital gain for 1939		3,500

In the case of individuals, gains and losses from the sale or exchange of capital assets held for not more than 18 months (described as short-term capital gains and short-term capital losses) shall be segregated from gains and losses arising from the sale or exchange of such assets held for more than 18 months (described as long-term capital gains and long-term capital losses). This segregation is applicable only to the capital gains and capital losses of individuals and does not apply to corporations, since the percentage brackets of section 117 (b) have no application to corporations, corporate gains and losses being taken into account to the full extent, without regard to the length of time the capital assets are held (though because of the limitation in section 117 (d) such losses may not be deductible in full).

See section 23 (g) and (k), under which losses from worthless stocks, bonds, and other securities (if they constitute capital assets) are required to be treated as losses under section 117 from the sale or exchange of capital assets, even though such securities are not actually sold or exchanged.

ART. 117-2. *Percentage of capital gain or loss taken into account: Net loss carry-over.*—In computing the net income of a taxpayer, other than a corporation, the amount of the gain or loss, computed under section 111 and recognized under section 112, upon the sale or exchange of a capital asset shall be taken into account only to the extent provided in section 117 (b). The percentage of the gain or loss to be taken into account ranges from 100 percent to 50 percent, depending upon the period for which the asset was held. For instance, if unimproved real estate purchased by an individual for $20,000 is a capital asset and is sold by him for $25,000 after having been held for more than two years, only 50 percent of the recognized gain ($5,000), or $2,500, shall be taken into account in computing net income; or if such property is sold for $14,000, only 50 percent of the recognized loss ($6,000), or $3,000, shall be so taken into account.

Section 117 (d) (1) provides a limitation on deductions for capital losses affecting corporations, that is, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of $2,000 plus the gains from such sales or exchanges. However, in the case of certain banks or trust companies, this limitation is subject to the modification provided in that section. Section 117 (d) (2) provides a further limitation on deductions for short-term capital losses of taxpayers other than corporations, that is, losses from sales or exchanges of capital assets held for 18 months or less shall be allowed as deductions only to the extent of the gains from sales or exchanges of capital assets held for 18 months or less. However, subsection (e) of section 117 provides that a taxpayer (other than a corporation) having in any taxable year (beginning after December 31, 1937) a net short-term capital loss, may carry over such loss, in an amount not in excess of his net income for such year (the year in which the loss is realized), to the next succeeding taxable year and treat it in such succeeding year as a short-term capital loss. The carry-over is thus applied in such succeeding year to offset any short-term capital gains in such succeeding year not already offset by short-term capital losses in such year. The carry-over is restricted to one year, namely, the succeeding taxable year, and hence the amount of the net short-term capital loss carry-over may not be included in computing a new net short-term capital loss which can be carried over to the second succeeding taxable year.

The practical operation of the provisions of this article may be illustrated by the following examples:

Example (1): During the taxable year 1938, A, an individual, has ordinary net income (net income exclusive of gains or losses from sales or exchanges of capital assets) of $6,000 and gains and losses resulting from sales or exchanges of capital assets as follows:

Short-Term Capital Gains and Losses

Asset	Gain	Loss	Holding period	Percentage under section 117 (b)	Amount taken into account: Gain	Amount taken into account: Loss
			Months			
Corporation stock		$10,000	18	100		$10,000
Corporation bonds	$4,000		12	100	$4,000	
Government bonds	3,000		10	100	3,000	
Short-term capital loss taken into account						10,000
Short-term capital gain taken into account					7,000	
Net short-term capital loss						3,000

Long-Term Capital Gains and Losses

Asset	Gain	Loss	Holding period	Percentage under section 117 (b)	Amount taken into account: Gain	Amount taken into account: Loss
			Months			
Corporation stock		$12,000	19	66⅔		$8,000
Corporation bonds		6,000	49	50		3,000
Government bonds	$1,000		25	50	$500	
Real estate	9,000		23	66⅔	6,000	
Long-term capital loss taken into account						11,000
Long-term capital gain taken into account					6,500	
Net long-term capital loss						4,500

Computation of Net Income

Ordinary net income		$6,000
Short-term capital gains		7,000
Long-term capital gains		6,500
Total		19,500
Deduct:		
Short-term capital loss (to extent of short-term capital gains)	$7,000	
Long-term capital loss	11,000	
		18,000
Net income		1,500

Example (2): For the taxable year 1939 the same individual as in Example (1) has ordinary net income (net income other than gains or losses from sales or exchanges of capital assets) of $6,000; short-term capital gains of $5,500; and short-term capital losses of $5,000. His long-term capital gains and losses *to be taken into account* in computing net income consist of the following: Long-term capital gains, $7,000; long-term capital losses, $6,000. His net income is computed as follows:

Ordinary net income		$6,000
Short-term capital gains		5,500
Long-term capital gains		7,000
Total		18,500
Deduct:		
Short-term capital loss:		
(1) Realized during taxable year (subject to section 117 (d) (2))	$5,000	
(2) Net short-term capital loss carry-over (not in excess of net income for 1938, $1,500), but not to exceed excess of short-term capital gains over short-term capital losses for 1939	500	
Long-term capital loss	6,000	
		11,500
Net income		7,000
Net short-term capital loss carry-over to 1940		None

ART. 117-3. *Alternative tax in case of net long-term capital gain or loss.*—In the case of a net long-term capital gain of a taxpayer other than a corporation, subsection (c) (1) of section 117 imposes an alternative tax in lieu of the tax imposed by sections 11 and 12, if and only if such alternative tax is less than the tax imposed by sections 11 and 12. This alternative tax is the sum of (1) a partial tax, computed at the rates provided by sections 11 and 12, on the net income of the taxpayer, excluding therefrom for

this purpose the amount of such net long-term capital gain, plus (2) 30 percent of the net long-term capital gain.

In the case of a net long-term capital loss of a taxpayer other than a corporation, an alternative tax is imposed in lieu of the tax imposed by sections 11 and 12, if and only if such tax is greater than the tax imposed by sections 11 and 12. This alternative tax is the excess of (1) a tax, at the rates provided by sections 11 and 12, on the net income of the taxpayer, but excluding from the computation of such net income, the amount of the net long-term capital loss over (2) 30 percent of the net long-term capital loss.

The following examples will illustrate the practical operation of the provisions of this article:

Example (1): Suppose that A, an individual, has for the calendar year 1938 an ordinary net income of $100,000, none of which consists of interest on the obligations of the United States or its instrumentalities. He is entitled to a personal exemption of $2,500 and to no credit for dependents, and his earned net income is $3,000. He realizes in that year a gain of $45,000 on a capital asset held for 19 months and a gain of $40,000 on a capital asset held for 26 months. Suppose, also, that A has no losses from the sale or exchange of capital assets. Since the alternative tax is less than the tax otherwise computed under sections 11 and 12, the correct tax is the alternative tax, that is, $47,513. The tax is computed as follows:

Tax Under Sections 11 and 12

Ordinary net income		$100,000
Capital gains:		
66⅔ percent of $45,000	$30,000	
50 percent of $40,000	20,000	
		50,000
Total net income		150,000
Less credit for personal exemption		2,500
Surtax net income		147,500
Less earned income credit (10 percent of $3,000)		300
Income subject to normal tax		147,200
Normal tax (4 percent of $147,200)		5,888
Surtax on $147,500		57,550
Total tax		63,438

Alternative Tax Under Section 117 (c) (1)

Net income	$150,000
Less net long-term capital gain	50,000
Ordinary net income	100,000
Less credit for personal exemption	2,500
Surtax net income	97,500
Less earned income credit (10 percent of $3,000)	300
Income subject to normal tax	97,200
Normal tax (4 percent of $97,200)	3,888
Surtax on $97,500	28,625
Partial tax under sections 11 and 12 on $100,000	32,513
Plus 30 percent of $50,000	15,000
Total alternative tax	47,513

Example (2): Suppose that in example (1) the facts with respect to net income and credits are the same, except that the taxpayer has for the calendar year 1938 an ordinary net income of $200,000, and that he realizes in that year a loss of $100,000 on a capital asset held for 5 years, and that he has no gains from the sale or exchange of capital assets. Since the alternative tax is greater than the tax otherwise computed under sections 11 and 12, the correct tax is the alternative tax, that is, $80,388. The tax is computed as follows:

Tax Under Sections 11 and 12

Ordinary net income	$200,000
Less net long-term capital loss (50 percent of $100,000)	50,000
Net income subject to tax	150,000
Less credit for personal exemption	2,500
Surtax net income	147,500
Less earned income credit (10 percent of $3,000)	300
Net income subject to normal tax	147,200
Normal tax (4 percent of $147,200)	5,888
Surtax on $147,500	57,550
Total tax	63,438

Alternative Tax Under Section 117 (c) (2)

Net income (excluding from the computation $50,000, the amount of the net long-term capital loss)	$200,000
Less credit for personal exemption	2,500
Surtax net income	197,500
Less earned income credit (10 percent of $3,000)	300
Income subject to normal tax	197,200
Normal tax (4 percent of $197,200)	7,888
Surtax on $197,500	87,500
Partial tax under sections 11 and 12 on $200,000	95,388
Less 30 percent of $50,000	15,000
Alternative tax	80,388

ART. 117–4. *Determination of period for which capital assets are held.*—Under section 117 (h) if property is acquired in certain transactions described in sections 112, 113, 118, and 371 (c), the period for which such property is considered to have been held by the taxpayer is not computed from the date such property was acquired by the taxpayer but from a prior date. For instance: In the case of stock or securities in a corporation a party to a reorganization received pursuant to a plan of reorganization in exchange solely for stock or securities in another corporation a party to the reorganization, the period for which the stock or securities exchanged were held by the taxpayer must be included in the period for which the stock or securities received on the exchange were held by the taxpayer. In the case of property acquired after December 31, 1920, by gift (if under the provisions of section 113, such property has, for the purpose of determining gain or loss from the sale or exchange, the same basis in the hands of the taxpayer as it would have in the hands of the donor), the period for which the property was held by the donor must be included in the period for which the property was held by the taxpayer. In the case of stock or securities the acquisition of which resulted in the nondeductibility (under section 118, Revenue Act of 1928, 1932, 1934, 1936, or 1938) of the loss from the sale or other disposition of substantially identical stock or securities, the period for which the stock or securities the loss from the sale or other disposition of which was not deductible were held must be included in the period for which the stock or securities acquired were held by the taxpayer.

The period for which the taxpayer has held stock issued to him as a nontaxable stock dividend shall be determined as though the stock dividend were the stock in respect of which the dividend was issued.

ART. 117–5. *Application of section 117 in the case of husband and wife*—(a) *Short-term capital gains and losses.*—Under the general rule with respect to taking deductions in a joint return of husband and wife (see article 51–1), a deduction which is not allowable in computing the net income of one spouse making a separate return is not allowable in a joint return made by both spouses. Hence, the limitation under section 117 (d) (2), relating to the allowance of short-term capital losses, is, in the case of one spouse, to be computed without regard to the short-term capital gains and losses of the other spouse, regardless of whether a joint return or separate returns are filed.

(b) *Long-term capital gains and losses.*—In the case of a joint return, the tax under sections 11 and 12 is imposed upon the aggregate net income of both spouses, after giving effect to the deductions to which each spouse would be entitled in a separate return (see article 51–1). The allowance of a long-term capital loss is not subject to a limitation such as that contained in section 117 (d) (2). Accordingly, in the case of a joint return, the long-term capital losses of either spouse may be deducted from the aggregate income in computing the tax imposed under sections 11 and 12. The alternative taxes computed under section 117 (c) are in lieu of the tax imposed by sections 11 and 12 and must be compared with the tax imposed by such sections to determine which tax is applicable. Therefore, in computing the alternative taxes under section 117 (c) in the case of a joint return, the determination of the "net long-term capital gain" or the "net long-term capital loss" is to be made by first aggregating the long-term capital gains, and the long-term capital losses, respectively, of both spouses.

ART. 117–6. *Gains and losses from short sales.*—For income tax purposes, a short sale is not deemed to be consummated until delivery of property to cover the short sale, and the percentage of the recognized gain or loss to be taken into account under section 117 (b) from a short sale shall be computed according to the period for which the property so delivered was held. Thus, if a taxpayer made a short sale of shares of stock and covered the short sale by purchasing and delivering shares which he held for not more than 18 months, 100 percent of the recognized gain or loss would be taken into account under section 117 (b), even though he had on hand other shares of the same stock which he held for more than 18 months. If, however, he covered the short sale by delivering shares which he held for more than 18 months but not for more than 24 months, only 66⅔ percent of the recognized gain or loss would be taken into account. If the short sale is made through a broker and the broker borrows property to make delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

CHAPTER XVIII

Loss From Wash Sales

SEC. 118. *Loss from wash sales of stock or securities.*—(a) In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction for the loss shall be allowed under section 23 (e) (2); nor shall such deduction be allowed under section 23 (f) unless the claim is made by a corporation, a dealer in stocks or securities, and with respect to a transaction made in the ordinary course of its business.

(b) If the amount of stock or securities acquired (or covered by the contract or option to acquire) is less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the loss from the sale or other disposition of which is not deductible shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

(c) If the amount of stock or securities acquired (or covered by the contract or option to acquire) is not less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility of the loss shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

ART. 118-1. *Losses from wash sales of stock or securities.*—(*a*) A taxpayer cannot deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities, if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date (referred to in this article as the 61-day period), he has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities. However, this prohibition does not apply (1) in the case of a taxpayer, not a corporation, if the sale or other disposition of stock or securities is made in connection with the taxpayer's trade or business, or (2) in the case of a corporation, a dealer in stock or securities, if the sale or other disposition of stock or securities is made in the ordinary course of its business as such dealer. See article 22 (a)-8 as to stock or securities sold from lots purchased at different dates or at different prices where the identity of the lots cannot be determined and article 113 (a) (10)-1 for the basis for determining gain or loss from the subsequent sale or other disposition of stock or securities acquired in connection with wash sales.

(*b*) Where more than one loss is claimed to have been sustained within the taxable year from the sale or other disposition of stock or securities, the provisions of this article shall be applied to the losses in the order in which the stock or securities the disposition of which resulted in the respective losses were disposed of (beginning with the earliest disposition). If the order of disposition of stock or securities disposed of at a loss on the same day cannot be determined, the stock or securities will be considered to have been disposed of in the order in which they were originally acquired (beginning with the earliest acquisition).

(*c*) Where the amount of stock or securities acquired within the 61-day period is less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the loss from the sale or other disposition of which is not deductible shall be those with which the stock or securities acquired are matched in accordance with the following rule:

The stock or securities acquired will be matched in accordance with the order of their acquisition (beginning with the earliest acquisition) with an equal number of the shares of stock or securities sold or otherwise disposed of.

(*d*) Where the amount of stock or securities acquired within the 61-day period is not less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the acquisition of which resulted in the nondeductibility of the loss shall be those with which the stock or securities disposed of are matched in accordance with the following rule:

The stock or securities sold or otherwise disposed of will be matched with an equal number of the shares of stock or securities acquired in accordance with the order of acquisition (beginning with the earliest acquisition) of the stock or securities acquired.

(*e*) The acquisition of any share of stock or any security which results in the nondeductibility of a loss under the provisions of this article shall be disregarded in determining the deductibility of any other loss.

(*f*) The word "acquired" as used in this article means acquired by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law, and comprehends cases where the taxpayer has entered into a contract or option within the 61-day period to acquire by purchase or by such an exchange.

Example (1): A, whose taxable year is the calendar year, on December 1, 1937, purchased 100 shares of common stock in the M Company for $10,000 and on December 15, 1937, purchased 100 additional shares for $9,000. On January 2, 1938, he sold the 100 shares purchased on December 1, 1937, for $9,000. Because of the provisions of section 118 no loss from the sale is allowable as a deduction.

Example (2): A, whose taxable year is the calendar year, on September 21, 1937, purchased 100 shares of the common stock of the M Company for $5,000. On December 21, 1937, he purchased 50 shares of substantially identical stock for $2,750, and on December 26, 1937, he purchased 25 additional shares of such stock for $1,125. On January 2, 1938, he sold for $4,000 the 100 shares purchased on September 21, 1937. There is an indicated loss of $1,000 on the sale of the 100 shares. Since within the 61-day period A purchased 75 shares of substantially identical stock, the loss on the sale of 75 of the shares ($3,750-$3,000, or $750) is not allowable as a deduction because of the provisions of section 118. The loss on the sale of the remaining 25 shares ($1,250-$1,000, or $250) is deductible subject to the limitations provided in sections 24 (b) and 117. The basis of the 50 shares purchased December 21, 1937, the acquisition of which resulted in the nondeductibility of the loss ($500) sustained on 50 of the 100 shares sold on January 2, 1938, is $2,500 (the cost of 50 of the shares sold on January 2, 1938), plus $750 (the difference between the purchase price of the 50 shares acquired on December 21, 1937 ($2,750) and the selling price of 50 of the shares sold on January 2, 1938 ($2,000)), or $3,250. Similarly the basis of the 25 shares purchased on December 26, 1937, the acquisition of which resulted in the nondeductibility of the loss ($250) sustained on 25 of the shares sold on January 2, 1938, is $1,250 plus $125, or $1,375. (See article 113 (a) (10)-1.)

Example (3): A, whose taxable year is the calendar year, on September 15, 1936, purchased 100 shares of the stock of the M Company for $5,000. He sold these shares on February 1, 1938, for $4,000.

On each of the four days from February 15, 1938, to February 18, 1938, he purchased 50 shares of substantially identical stock for $2,000. There is an indicated loss of $1,000 from the sale of the 100 shares on February 1, 1938, but, since within the 61-day period A purchased not less than 100 shares of substantially identical stock, the loss is not deductible. The particular shares of stock the purchase of which resulted in the nondeductibility of the loss are the first 100 shares purchased within such period, that is, the 50 shares purchased on February 15, 1938, and the 50 shares purchased on February 16, 1938. In determining the period for which the 50 shares purchased on February 15, 1938, and the 50 shares purchased on February 16, 1938, were held, there is to be included the period for which the 100 shares purchased on September 15, 1936, and sold on February 1, 1938, were held.

CHAPTER XIX

Income From Sources Within United States

SEC. 119. *Income from sources within United States.—(a) Gross income from sources in United States.*—The following items of gross income shall be treated as income from sources within the United States:

(1) *Interest.*—Interest from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including—

(A) interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States and not having an office or place of business therein, or

(B) interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the Commissioner that less than 20 per centum of the gross income of such resident payor or domestic corporation has been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such payor preceding the payment of such interest, or for such part of such period as may be applicable, or

(C) income derived by a foreign central bank of issue from bankers' acceptances;

(2) *Dividends.*—The amount received as dividends—

(A) from a domestic corporation other than a corporation entitled to the benefits of section 251, and other than a corporation less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner to have been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence), or

(B) from a foreign corporation unless less than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this section; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the United States bears to its gross income from all sources; but dividends from a foreign corporation shall, for the purposes of section 131 (relating to foreign tax credit), be treated as income from sources without the United States;

(3) *Personal services.*—Compensation for labor or personal services performed in the United States, but in the case of a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of ninety days during the taxable year, compensation received by such an individual (if such compensation does not exceed $3,000 in the aggregate) for labor or services performed as an employee of or under a contract with a nonresident alien, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, shall not be deemed to be income from sources within the United States;

(4) *Rentals and royalties.*—Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

(5) *Sale of real property.*—Gains, profits, and income from the sale of real property located in the United States.

(6) *Sale of personal property.*—For gains, profits, and income from the sale of personal property, see subsection (e).

(*b*) *Net income from sources in United States.*—From the items of gross income specified in subsection (a) of this section there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States.

(*c*) *Gross income from sources without United States.*—The following items of gross income shall be treated as income from sources without the United States:

(1) Interest other than that derived from sources within the United States as provided in subsection (a) (1) of this section;

(2) Dividends other than those derived from sources within the United States as provided in subsection (a) (2) of this section;

(3) Compensation for labor or personal services performed without the United States;

(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties; and

(5) Gains, profits, and income from the sale of real property located without the United States.

(*d*) *Net income from sources without United States.*—From the items of gross income specified in subsection (c) of this section there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as net income from sources without the United States.

(*e*) *Income from sources partly within and partly without United States.*—Items of gross income, expenses, losses and deductions, other than those specified in subsections (a) and (c) of this section, shall be allocated or apportioned to sources within or without the United States, under rules and regulations prescribed by the Commissioner with the approval of the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the net income therefrom) the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States. In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some items or class of gross income; and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Commissioner with the approval of the Secretary. Gains, profits, and income from—

(1) transportation or other services rendered partly within and partly without the United States, or

(2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States,

shall be treated as derived partly from sources within and partly from sources without the United States. Gains, profits, and income derived from the purchase of personal property within and its sale without the United States or from the purchase of personal property without and its sale within the United States, shall be treated as derived entirely from sources within the country in which sold, except that gains, profits, and income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States.

(*f*) *Definitions.*—As used in this section the words "sale" or "sold" include "exchange" or "exchanged"; and the word "produced" includes "created", "fabricated", "manufactured", "extracted", "processed", "cured", or "aged".

ART. 119–1. *Income from sources within the United States.*—Nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations entitled to the benefits of section 251 are taxable only upon income from sources within the United States. Citizens of the United States and domestic corporations entitled to the benefits of section 251 are, however, taxable upon income received within the United States, whether derived from sources within or without the United States. (See sections 212 (a), 231 (c), and 251.)

The Act divides the income of such taxpayers into three classes:

(1) Income which is derived in full from sources within the United States;

(2) Income which is derived in full from sources without the United States; and

(3) Income which is derived partly from sources within and partly from sources without the United States.

The taxable income from sources within the United States includes that derived in full from sources within the United States and that portion of the income which is derived partly from sources within and partly from sources without the United States which is allocated or apportioned to sources within the United States.

ART. 119-2. *Interest.*—There shall be included in the gross income from sources within the United States, of nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations which are entitled to the benefits of section 251, all interest received or accrued, as the case may be, from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except:

(*a*) Interest paid on deposits with persons, including individuals, partnerships, or corporations, carrying on the banking business, to persons (nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations entitled to the benefits of section 251) not engaged in business within the United States, and not having an office or place of business therein;

(*b*) Interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the Commissioner that less than 20 percent of the gross income of such resident payor or domestic corporation has been derived from sources within the United States (as determined under the provisions of section 119) for the 3-year period ending with the close of the taxable year of the payor which precedes the payment of such interest, or for such part of that period as may be applicable; and

(*c*) Income derived by a foreign central bank of issue from bankers' acceptances. A foreign central bank of issue means a bank which is by law or government sanction the principal authority (other than the government itself) issuing instruments intended to circulate as currency. Such banks are generally the custodians of the banking reserves of their countries.

Any taxpayer who excludes from gross income from sources within the United States income of the type specified in paragraph (*a*), (*b*), or (*c*) shall file with his return a statement setting forth the amount of such income and such information as may be necessary to show that the income is of the type specified in those paragraphs.

Interest received from the United States by a foreign corporation or a nonresident alien on a refund of Federal income taxes is taxable as income from sources within the United States.

As to the inclusion in gross income of items received in the United States even though representing income from sources without the United States, in the case of citizens of the United States and domestic corporations entitled to the benefits of section 251, see article 251-2.

ART. 119-3. *Dividends.*—Gross income from sources within the United States includes dividends, as defined by section 115:

(*a*) From a domestic corporation other than one entitled to the benefits of section 251, and other than a corporation less than 20 percent of the gross income of which is shown to the satisfaction of the Commissioner to have been derived from sources within the United States, as determined under the provisions of section 119, for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence); or

(*b*) From a foreign corporation unless less than 50 percent of its gross income for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends, or for such part of such period as it has been in existence, was derived from sources within the United States; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the United States bears to its gross income from all sources. However, for the purposes of section 131, relating to credits for taxes of foreign countries and possessions of the United States, dividends from a foreign corporation shall be treated as income from sources without the United States.

Dividends will be treated as income from sources within the United States (except for the purposes of section 131) unless the taxpayer submits sufficient data to establish to the satisfaction of the Commissioner that they should be excluded from gross income under (*a*) or (*b*) of this article. (See also section 116 (f).)

ART. 119-4. *Compensation for labor or personal services.*—Except as provided in section 119 (a) (3), gross income from sources within the United States includes compensation for labor or personal services performed within the United States regardless of the residence of the payor, of the place in which the contract for service was made, or of the place of payment. If a specific amount is paid for labor or personal services performed in the United States, such amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis, i. e., there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made. Except as provided in section 119 (a) (3), wages received for services rendered inside the territorial limits of the United States and wages of an alien seaman earned on a coastwise vessel are to be regarded as from sources within the United States.

ART. 119-5. *Rentals and royalties.*—Gross income from sources within the United States includes rentals or royalties from property located within the United States or from any interest in such property, including rentals or royalties for the use of or the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property. The income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether tangible or intangible, within the United States, is from sources within the United States.

ART. 119-6. *Sale of real property.*—Gross income from sources within the United States includes gain, computed under the provisions of sections 111-113, derived from the sale or other disposition of real property located in the United States. For the treatment of capital gains and losses, see section 117.

ART. 119-7. *Income from sources without the United States.*—Gross income from sources without the United States includes:

(1) Interest other than that specified in section 119 (a) (1), as being derived from sources within the United States;

(2) Dividends other than those derived from sources within the United States as provided in section 119 (a) (2);

(3) Compensation for labor or personal services performed without the United States (for the treatment of compensation for labor or personal services performed partly within the United States and partly without the United States, see article 119-4);

(4) Rentals or royalties derived from property without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property (see article 119-5); and

(5) Gain derived from the sale of real property located without the United States (see sections 111-113).

ART. 119-8. *Sale of personal property.*—Income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which sold, except that income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States. A possession of the United States constitutes a "country," within the meaning of this article, separate and distinct from the United States. Hence income derived from the purchase of personal property within the United States and its sale within a possession of the United States shall be treated as derived entirely from within a possession of the United States. The word "sold" includes "exchanged." The "country in which sold" ordinarily means the place where the property is marketed. This article does not apply to income from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States or produced (in whole or in part) by the taxpayer without and sold within the United States. (See article 119-12.)

ART. 119-9. *Deductions in general.*—The deductions provided for in Title I shall be allowed to nonresident alien individuals and foreign corporations engaged in trade or business within the United States or having an office or place of business therein, and to citizens of the United States and domestic corporations entitled to the benefits of section 251, only if and to the extent provided in sections 213, 215, 232, 233, and 251.

ART. 119-10. *Apportionment of deductions.*—From the items specified in articles 119-1 to 119-6 as being derived specifically from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which can not definitely be allocated to some item or class of gross income. The remainder shall be included in full as net income from sources within the United States. The ratable part is based upon the ratio of gross income from sources within the United States to the total gross income.

Example: A nonresident alient individual (engaged in trade or business within the United States or having an office or place of business therein) whose taxable year is the calendar year, derived gross income from all sources for 1938 of $180,000, including therein:

Interest on bonds of a domestic corporation	$9,000
Dividends on stock of a domestic corporation	4,000
Royalty for the use of patents within the United States	12,000
Gain from sale of real property located within the United States	11,000
Total	36,000

that is, one-fifth of the total gross income was from sources within the United States. The remainder of the gross income was from sources without the United States, determined under article 119-7.

The expenses of the taxpayer for the year amounted to $78,000. Of these expenses the amount of $8,000 is properly allocated to income from sources within the United States and the amount of $40,000 is properly allocated to income from sources without the United States.

The remainder of the expenses, $30,000, cannot be definitely allocated to any class of income. A ratable part thereof, based upon the relation of gross income from sources within the United States to the total gross income, shall be deducted in computing net income from sources within the United States. Thus, there are deducted from the $36,000 of gross income from sources within the United States expenses amounting to $14,000 (representing $8,000 properly apportioned to the income from sources within the United States and $6,000, a ratable part (one-fifth) of the expenses which could not be allocated to any item or class of gross income). The remainder, $22,000, is the net income from sources within the United States.

ART. 119-11. *Other income from sources within the United States.*—Items of gross income other than those specified in section 119 (a) and (c) shall be allocated or apportioned to sources within or without the United States, as provided in section 119 (e).

The income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, located within the United States, and from the sale by the producer of the products thereof within or without the United States, shall ordinarily be included in gross income from sources within the United States. If, however, it is shown to the satisfaction of the Commissioner that due to the peculiar conditions of production and sale in a specific case or for other reasons all of such gross income should not be allocated to sources within the United States, an apportionment thereof to sources within the United States and to sources without the United States shall be made as provided in article 119-12.

Where items of gross income are separately allocated to sources within the United States, there shall be deducted therefrom, in computing net income, the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

ART. 119-12. *Income from the sale of personal property derived from sources partly within and partly without the United States.*—Items of gross income not allocated by articles 119-1 to 119-8 or 119-11 to sources within or without the United States shall (unless unmistakably from a source within or a source without the United States) be treated as derived from sources partly within and partly without the United States. Such income derived from the sale of personal property may be divided into two classes: (A) income derived from sources partly within the United States and partly within a foreign country, and (B) income derived from sources partly within the United States and partly within a possession of the United States.

A. The portion of such income derived from sources partly within the United States and partly within a foreign country which is attributable to sources within the United States shall be determined according to the following rules and cases:

Personal property produced and sold.—Gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States shall be treated as derived partly from sources within the United States and partly from sources within a foreign country under one of the cases named below. As used herein the word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged.

Case 1-A.—Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the Commissioner that such an independent factory or production price has been otherwise established—unaffected by considerations of tax liability, and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the net income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department, at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return.

Case 2-A.—Where an independent factory or production price has not been established as provided under case 1-A, the net income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. Of the amount of net income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the foreign country. The remaining one-half of such net income shall be apportioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within the United States and within the foreign country. The "gross sales of the taxpayer within the United States" means the gross sales made during the taxable year which were principally secured, negotiated, or effected by employees, agents, offices, or branches of the taxpayer's business resident or located in the United States. The term "gross sales" as used in this paragraph refers only to the sales of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, and the term "property" includes only the property held or used to produce income which is derived from such sales. Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion, or other purposes of taxation shall be the highest amount at which so valued or appraised, and which in other cases shall be deemed to be its book value in the absence of affirmative evidence showing such value to be greater or less than the actual value. The average value during the taxable year or period shall be employed. The average value of property as above prescribed at the beginning and end of the taxable year or period ordinarily may be used, unless by reason of material changes during the taxable year or period such average does not fairly represent the average for such year or period, in which event the average shall be determined upon a monthly or daily basis. Bills and accounts receivable shall (unless satisfactory reason for a different treatment is shown) be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, branch, or agent in the United States.

Case 3-A.—Application for permission to base the return upon the taxpayer's books of account will be considered by the Commissioner in the case of any taxpayer who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the processes or formulas herein prescribed, the income derived from sources within the United States.

B. The portion of such income derived from sources partly within the United States and partly within a possession of the United States which is attributable to sources within the United States shall be determined according to the following rules and cases:

Personal property produced and sold.—Gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States shall be treated as derived partly from sources within the United States and partly from sources within a possession of the United States under one of the cases named below. As used herein the word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged.

Case 1-B.—Same as case 1-A.

Case 2-B.—Where an independent factory or production price has not been established as provided under case 1-A, the net income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States, the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. Of the amount of net income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the possession of the United States. The remaining one-half of such net income shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the amount of the taxpayer's business for the taxable year or period within the United States, and the denominator of which consists of the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States. The "business of the taxpayer" as that term is used in this paragraph shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies consumed in the regular course of business, plus the amounts received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the production (in whole or in part) of personal property within the United States and its sale within a possession of the United States or to the production (in whole or in part) of personal property within a possession of the United States and its sale within the United States. The term "property" as used in this paragraph includes only the property held or used to produce income which is derived from such sales.

Case 3-B.—Same as case 3-A.

Personal property purchased and sold.—Gross income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within the United States and partly from sources within a possession of the United States under one of the following cases:

Case I-B.—The net income shall first be computed by deducting from such gross income the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The amount of net income so determined shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being that percentage of such net income which the amount of the taxpayer's business for the taxable year or period within the United States bears to the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States. The "business of the taxpayer" as that term is used in this paragraph shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies sold or consumed in the regular course of business, plus the amount received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the purchase of personal property within a possession of the United States and its sale within the United States.

Case II-B.—Same as case 3-A.

ART. 119-13. *Transportation service.*—A foreign corporation carrying on the business of transportation, service between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(1) The gross income from sources within the United States derived from such services shall be determined by taking such a portion of the total gross revenues therefrom as (*a*) the sum of the costs or expenses of such transportation business carried on by the taxpayer within the United States and a reasonable return upon the property used in its transportation business while within the United States bears to (*b*) the sum of the total costs or expenses of such transportation business carried on by the taxpayer and a reasonable return upon the total property used in such transportation business. Revenues from operations incidental to transportation services (such as the sale of money orders) shall be apportioned on the same basis as direct revenues from transportation services.

In allocating the total costs or expenses incurred in such transportation business, costs or expenses incurred in connection with that part of the services which was wholly rendered in the United States should be assigned to the cost of transportation business within the United States. For example, expenses of loading and unloading in the United States, rentals, office expenses, salaries, and wages wholly incurred for services rendered to the taxpayer in the United States belong to this class. Costs and expenses incurred in connection with services rendered partly within and partly without the United States may be prorated on a reasonable basis between such services. For example, ship wages, charter money, insurance, and supplies chargeable to voyage expenses should ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days on the voyage, and fuel consumed on each voyage may be prorated on the basis of the proportion which the number of miles sailed within the territorial limits of the United States bears to the total number of miles sailed on the voyage. Income, war-profits, and excess-profits taxes should not be regarded as costs or expenses for the purpose of determining the proportion of gross income from sources within the United States; and for such purpose, interest and other expenses for the use of borrowed capital should not be taken into the cost of services rendered, for the reason that the return upon the property used measures the extent to which such borrowed capital is the source of the income. For other expenses entering into the cost of services, only such expenses as are allowable deductions under the Revenue Act of 1938 should be taken.

The value of the property used should be determined upon the basis of cost less depreciation. Eight percent may ordinarily be taken as a reasonable rate of return to apply to such property. The property taken should be the average property employed in the transportation service between points in the United States and points outside the United States during the taxable year. Current assets should be decreased by current liabilities and allocated to services between the United States and foreign countries and to other services. The part allocated to services between the United States and foreign countries should be based on the proportion which the gross receipts from such services bear to the gross receipts from all services. The amount so allocated to services between the United States and foreign countries should be further allocated to services rendered within the United States and to services rendered without the United States. The portion allocable to services rendered within the United States should be based on the proportion which the expenses incurred within the territorial limits of the United States bear to the total expenses incurred in services between the United States and foreign countries. For ships the average should be determined upon a daily basis for each ship and the amount to be apportioned for each ship as assets employed within the United States should be computed upon the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days the ship was in service during the taxable period. For other assets employed in the transportation business, the average of the assets at the beginning and end of the taxable period ordinarily may be taken, but if the average so obtained does not, by reason of material changes during the taxable year, fairly represent the average for such year either for the assets employed in the transportation business in the United States or in total, the average must be determined upon a monthly or daily basis.

(2) In computing net income from sources within the United States there shall be allowed as deductions from the gross income as determined in accordance with paragraph (1), (*a*) the expenses of the transportation business carried on within the United States as determined under paragraph (1), and (*b*) the expenses determined in accordance with paragraphs (3) and (4).

(3) Interest and income, war-profits, and excess-profits taxes should be excluded from the apportionment process, as explained in paragraph (1); but for the purpose of computing net income there may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined, a ratable part (*a*) of all interest (deductible under section 23 (b)), and (*b*) of all income, war-profits, and excess-profits taxes (deductible under section 23 (c) and (d)), paid or accrued in respect of the business of transportation service between points in the United States and points outside the United States. Such ratable part should ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income from such transportation service.

(4) If a foreign corporation subject to this article is also engaged in a business other than that of providing transportation service between points in the United States and points outside the United States, the costs and expenses (including taxes) properly apportioned or allocated to such other business should be excluded both from the deductions and from the apportionment process prescribed in paragraph (1); but, for the purpose of determining net income, a ratable part of any general expenses, losses, or deductions, which cannot definitely be allocated to some item or class of gross income, may be deducted from the gross income from sources within the United States after the amount of such gross income has been determined. Such ratable part should ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income.

(5) Application for permission to base the return upon the taxpayer's books of account will be considered by the Commissioner in the case of any taxpayer subject to this article, who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the process prescribed in paragraphs (1)-(4), the income derived from sources within the United States.

ART. 119-14. *Telegraph and cable service.*—A foreign corporation carrying on the business of transmission of telegraph or cable messages between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(1) *Gross income.*—The gross income from sources within the United States derived from such services shall be deter-

mined by adding (*a*) its gross revenues derived from messages originating in the United States and (*b*) amounts collected abroad on collect messages originating in the United States and deducting from such sum amounts paid or accrued for transmission of messages beyond the company's own circuit. Amounts received by the company in the United States with respect to collect messages originating without the United States shall be excluded from gross income.

(2) *Net income.*—In computing net income from sources within the United States there shall be allowed as deductions from gross income determined in accordance with paragraph (1), (*a*) all expenses incurred in the United States (not including any general overhead expenses) incident to the carrying on of the business in the United States, (*b*) all direct expenses incurred abroad in the transmission of messages originating in the United States (not including any general overhead expenses or maintenance, repairs, and depreciation of cables and not including any amount already deducted in computing gross income), (*c*) depreciation of property (other than cables) located in the United States and used in the trade or business therein, and (*d*) a proportionate part of the general overhead expenses (not including any items incurred abroad corresponding to those enumerated in (*a*), (*b*), and (*c*)) and of maintenance, repairs, and depreciation of cables of the entire cable system of the enterprise based on the ratio which the number of words originating in the United States bears to the total words transmitted by the enterprise.

ART. 119-15. *Computation of income.*—If a taxpayer has gross income from sources within or without the United States as defined by section 119 (a) or (c) together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investments applicable thereto, shall be segregated, and the net income from sources within the United States shall be separately computed therefrom.

CHAPTER XX

Certain Deductions for Charitable and Other Contributions and Dividends Paid

SEC. 120. *Unlimited deduction for charitable and other contributions.*—In the case of an individual if in the taxable year and in each of the ten preceding taxable years the amount of the contributions or gifts described in section 23 (o) (or corresponding provisions of prior revenue Acts) plus the amount of income, war-profits, or excess-profits taxes paid during such year in respect of preceding taxable years, exceeds 90 per centum of the taxpayer's net income for each such year, as computed without the benefit of the applicable subsection, then the 15 per centum limit imposed by section 23 (*o*) shall not be applicable.

SEC. 121. *Deduction of dividends paid on certain preferred stock of certain corporations.*—In computing the net income of any national banking association, or of any bank or trust company organized under the laws of any State, Territory, possession of the United States, or the Canal Zone, or of any other banking corporation engaged in the business of industrial banking and under the supervision of a State banking department or of the Comptroller of the Currency, or of any incorporated domestic insurance company, there shall be allowed as a deduction from gross income, in addition to deductions otherwise provided for in this title, any dividend (not including any distribution in liquidation) paid, within the taxable year, to the United States or to any instrumentality thereof exempt from Federal income taxes, on the preferred stock of the corporation owned by the United States or such instrumentality. The amount allowable as a deduction under this section shall be deducted from the basic surtax credit otherwise computed under section 27 (b).

CHAPTER XXI

Credits Against Tax—Supplemental

Supplement C—Credits Against Tax [Supplementary to Subtitle B, Part III]

SEC. 131. *Taxes of foreign countries and possessions of United States.*—(*a*) *Allowance of credit.*—If the taxpayer signifies in his return his desire to have the benefits of this section, the tax imposed by this title shall be credited with:

(1) *Citizen and domestic corporation.*—In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war-profits, and excess-profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(2) *Resident of United States.*—In the case of a resident of the United States, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

(3) *Alien resident of United States.*—In the case of an alien resident of the United States, the amount of any such taxes paid or accrued during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) *Partnerships and estates.*—In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(*b*) *Limit on credit.*—The amount of the credit taken under this section shall be subject to each of the following limitations:

(1) The amount of the credit in respect of the tax paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources within such country bears to his entire net income for the same taxable year; and

(2) The total amount of the credit shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources without the United States bears to his entire net income for the same taxable year.

(*c*) *Adjustments on payment of accrued taxes.*—If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner, who shall redetermine the amount of the tax for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 322. In the case of such a tax accrued but not paid, the Commissioner, as a condition precedent to the allowance of this credit, may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such sum as the Commissioner may require, conditioned upon the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(*d*) *Year in which credit taken.*—The credits provided for in this section may, at the option of the taxpayer and irrespective of the method of accounting employed in keeping his books, be taken in the year in which the taxes of the foreign country or the possession of the United States accrued, subject, however, to the conditions prescribed in subsection (c) of this section. If the taxpayer elects to take such credits in the year in which the taxes of the foreign country or the possession of the United States accrued, the credits for all subsequent years shall be taken upon the same basis, and no portion of any such taxes shall be allowed as a deduction in the same or any succeeding year.

(*e*) *Proof of credits.*—The credits provided in this section shall be allowed only if the taxpayer establishes to the satisfaction of the Commissioner (1) the total amount of income derived from sources without the United States, determined as provided in section 119, (2) the amount of income derived from each country, the tax paid or accrued to which is claimed as a credit under this section, such amount to be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary, and (3) all other information necessary for the verification and computation of such credits.

(*f*) *Taxes of foreign subsidiary.*—For the purposes of this section a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid by such foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits: *Provided*, That the amount of tax deemed to have been paid under this subsection shall in no case exceed the same proportion of the tax against which credit is taken which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. The term "accumulated profits" when used in this subsection in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income; and the Commissioner with the approval of the Secretary shall have full power to determine from the accumulated profits of what year or years such dividends were paid; treating dividends paid in the first sixty days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings. In the case of a foreign corporation, the income, war-profits, and excess-profits taxes of which are determined on the basis of an accounting period of less than one year, the word "year" as used in this subsection shall be construed to mean such accounting period.

(*g*) *Corporations treated as foreign.*—For the purposes of this section the following corporations shall be treated as foreign corporations:

(1) A corporation entitled to the benefits of section 251, by reason of receiving a large

percentage of its gross income from sources within a possession of the United States;

(2) A corporation organized under the China Trade Act, 1922, and entitled to the credit provided for in section 262.

ART. 131–1. *Analysis of credit for taxes.*—If the taxpayer signifies in his return his desire to claim a credit for taxes, the basis of such credit, in the case of a citizen of the United States, whether resident or nonresident, and in the case of a domestic corporation, is as follows: (*a*) The amount of any income, war-profits, and excess-profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and (*b*) an individual's proportionate share of any such taxes of a partnership of which he is a partner or of an estate or trust of which he is a beneficiary paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be.

In the case of an alien resident of the United States who signifies in his return his desire to claim a credit for such taxes the basis of the credit is as follows: (*a*) The amount of any such taxes paid or accrued during the taxable year to any possession of the United States; (*b*) the amount of any such taxes paid or accrued during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and (*c*) his proportionate share of any such taxes of a partnership of which he is a partner or of an estate or trust of which he is a beneficiary paid or accrued during the taxable year to any possession of the United States, or to any foreign country, as the case may be, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country.

If a taxpayer signifies in his return his desire to claim a credit for taxes, such action will be considered to apply to income, war-profits, and excess-profits taxes paid to all foreign countries and possessions of the United States, and no portion of any such taxes shall be allowed as a deduction from gross income.

A citizen of the United States or a domestic corporation entitled to the benefits of section 251, or a China Trade Act corporation, is not allowed any of the credits provided by section 131.

ART. 131–2. *Meaning of terms.*—The "amount of any income, war-profits, and excess-profits taxes paid or accrued during the taxable year" means taxes proper (no credit being given for amounts representing interest or penalties) paid or accrued during the taxable year on behalf of the taxpayer claiming credit. "Foreign country" means any foreign state or political subdivision thereof, or any foreign political entity, which levies and collects income, war-profits, or excess-profits taxes. "Any possession of the United States" includes, among others, Puerto Rico, the Philippines, and the Virgin Islands. But see section 251. As to the meaning of "sources," see section 119. (See also section 901.)

ART. 131–3. *Conditions of allowance of credit.*—If the taxpayer signifies in his return his desire to claim credit for income, war-profits, or excess-profits taxes paid other than to the United States, the income tax return must be accompanied by Form 1116 in the case of an individual, and by Form 1118 in the case of a corporation. The form must be carefully filled in with all the information there called for and with the calculations of credits there indicated, and must be duly signed and sworn to or affirmed. If credit is sought for taxes already paid the form must have attached to it the receipt for each such tax payment. If credit is sought for taxes accrued, the form must have attached to it the return on which each such accrued tax was based. This receipt or return so attached must be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. In case only a sworn copy of a receipt or return is attached, there must be kept readily available for comparison on request the original, a duplicate original, or a duly certified or authenticated copy. If the receipt or the return is in a foreign language, a certified translation thereof must be furnished by the taxpayer. Any additional information necessary for the determination under section 119 of the amount of income derived from sources without the United States and from each foreign country shall, upon the request of the Commissioner, be furnished by the taxpayer.

In the case of a credit sought for a tax accrued but not paid, the Commissioner may require as a condition precedent to the allowance of credit a bond from the taxpayer in addition to Form 1116 or 1118. If such a bond is required, Form 1117 shall be used by an individual and Form 1119 by a corporation. It shall be in such sum as the Commissioner may prescribe, and shall be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of the tax made necessary by such credit proving incorrect, with such further conditions as the Commissioner may require. This bond shall be executed by the taxpayer, or the agent or representative of the taxpayer, as principal, and by sureties satisfactory to and approved by the Commissioner. (See also section 1126 of the Revenue Act of 1926, as amended, paragraph 35 of the Appendix to these regulations.)

For credit where taxes are paid by a foreign corporation controlled by a domestic corporation, see article 131–7. A claim for credit in such a case is also to be made on Form 1118. See article 131–6 with reference to the option granted by section 131 (d).

If it is the desire of the taxpayer to claim as a credit and not as a deduction accrued income, war-profits, and excess-profits taxes imposed by the authority of any foreign country or possession of the United States but at the time the return is made it is impossible to estimate the amount of such taxes that may have accrued for the period for which the return is made, Form 1116 in the case of an individual, and Form 1118 in the case of a corporation, may be filed at a later date but a credit cannot be allowed for such taxes unless the taxpayer signifies in his return his desire to have to any extent the benefits of section 131.

ART. 131–4. *Redetermination of tax when credit proves incorrect.*—In case credit has been given for taxes accrued, or a proportionate share thereof, and the amount that is actually paid on account of such taxes, or a proportionate share thereof, is not the same as the amount of such credit, or in case any tax payment credited is refunded in whole or in part, the taxpayer shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of the income tax of such taxpayer for the year or years for which such incorrect credit was granted. The amount of tax, if any, due upon such redetermination shall be paid by the taxpayer upon notice and demand by the collector. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the taxpayer in accordance with the provisions of section 322.

ART. 131–5. *Countries which do or do not satisfy the similar credit requirement.*—A country satisfies the similar credit requirement of section 131 (a) (3), as to income tax paid to such country, either by allowing to citizens of the United States residing in such country a credit for the amount of income taxes paid to the United States, or, in imposing such taxes, by exempting from taxation the incomes received from sources within the United States by citizens of the United States residing in such country. A country does not satisfy the similar credit requirement of section 131 (a) (3) if it does not allow any credit to citizens of the United States residing in such country for the amount of income taxes paid to the United States, or if such country does not impose any income taxes. If the country of which a resident alien is a citizen or subject does not allow to a United States citizen residing in such country a credit for taxes paid by such citizen to another foreign country, no credit is allowed to such resident alien for taxes paid by him to such other foreign country.

ART. 131–6. *When credit for taxes may be taken.*—The credit for taxes provided by section 131 (a) may ordinarily be taken either in the return for the year in which the taxes accrued or in which the taxes were paid, dependent upon whether the accounts of the taxpayer are kept and his returns filed upon the accrual basis or upon the cash receipts and disbursements basis. Section 131 (d) allows the taxpayer, at his option and irrespective of the method of accounting employed in keeping his books, to take such credit for taxes as may be allowable in the return for the year in which the taxes accrued. An election thus made under this section or under section 222 (c) or 238 (c) of the Revenue Act of 1924 or 1926, or under section 131 (d) of the Revenue Act of 1928, 1932, 1934, or 1936, must be followed in returns for all subsequent years, and no portion of any such taxes will be allowed as a deduction from gross income.

ART. 131–7. *Domestic corporation owning a majority of the stock of foreign corporation.*—In the case of a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends in any taxable year, the credit for foreign taxes includes not only the income, war-profits, and excess-profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States by such domestic corporation, but also income, war-profits, and excess-profits taxes deemed to have been paid determined by taking the same proportion of any income, war-profits, and excess-profits taxes paid or accrued by such controlled foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of any such dividends received bears to the amount of such accumulated profits. The amount of taxes deemed to have been paid is limited, however, to an amount which shall in no case exceed the same proportion of the tax against which the credit for foreign taxes is taken, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. If dividends are received from more than one controlled foreign corporation, the limitation is to be computed separately for the dividends received from each controlled foreign corporation. If the credit for foreign taxes includes taxes deemed to have been paid, the taxpayer must furnish the same information with respect to the taxes deemed to have been paid as it is required to furnish with respect to the taxes actually paid or accrued by it. Taxes paid or accrued by a controlled foreign corporation are deemed to have been paid by the domestic corporation for purposes of credit only.

ART. 131–8. *Limitations on credit for foreign taxes.*—The amount of the income and profits taxes paid or accrued (including the taxes which, in accordance with the provisions of section 131 (f), are deemed to have been paid) during the taxable year to each foreign country or possession of the United States, limited under section 131 (b) (1) so as not to exceed that proportion of the tax against which credit is taken which the taxpayer's net income from sources within such country or possession bears to his entire net income for the same taxable year, is the tentative credit in respect of the taxes paid or accrued to such country or possession. The sum of these tentative credits, limited under section 131 (b) (2) so as not to exceed the same proportion of the tax against which credit is taken which the taxpayer's net income from sources without the United States bears to his entire net income for the same taxable year, is the amount allowable as a credit against the income tax under Title I for income or profits taxes paid or accrued to foreign countries or possessions of the United States.

The operation of the limitations on the credit for foreign taxes may be illustrated by the following examples:

Example (1): In 1938, A, a citizen of the United States, had a net income for services rendered within the United States amounting to $50,000 and a net income from sources within Great Britain of $25,000. He is entitled to a personal exemption of $1,000. The credit for foreign taxes allowable to A in his return for the calendar year 1938 is $6,494.67, computed as follows:

Income from sources within the United States	$50,000.00
Income from sources within Great Britain	25,000.00
Total net income	75,000.00
United States income tax on $75,000	19,484.00
British income and profits taxes	7,500.00
Limitation on British income and profits taxes under section 131 (b) (1) and (2) to determine credit $\left(\frac{25,000}{75,000} \text{ of } \$19,484\right)$	6,494.67
Credit for British income and profits taxes (total British income and profits taxes, reduced in accordance with the limitations under section 131 (b) (1) and (2))	6,494.67

Example (2): If, in example (1), above, A had a net income from sources within Great Britain of $15,000 and a net income from sources within Canada of $10,000 and the income and profits taxes paid or accrued to Great Britain and Canada were $4,000 and $1,200, respectively, the credit for foreign taxes allowable to A would be $5,096.80, computed as follows:

Income from sources within the United States	$50,000.00
Income from sources within Great Britain	15,000.00
Income from sources within Canada	10,000.00
Total net income	75,000.00
United States income tax on $75,000	19,484.00
British income and profits taxes	4,000.00
Limitation on British income and profits taxes under section 131 (b) (1) to determine tentative credit $\left(\frac{15,000}{75,000} \text{ of } \$19,484\right)$	3,896.80
Tentative credit for British income and profits taxes (total British income and profits taxes, reduced in accordance with the limitation under section 131 (b) (1))	3,896.80
Canadian income and profits taxes	1,200.00
Limitation on Canadian income and profits taxes under section 131 (b) (1) to determine tentative credit $\left(\frac{10,000}{75,000} \text{ of } \$19,484\right)$	2,597.86
Tentative credit for Canadian income and profits taxes (total Canadian income and profits taxes, since such amount is within the limitation under section 131 (b) (1))	1,200.00
Sum of tentative credits ($3,896.80 plus $1,200)	5,096.80
Limitation on sum of tentative credits under section 131 (b) (2) to determine credit $\left(\frac{25,000}{75,000} \text{ of } \$19,484\right)$	6,494.67
Total amount of credit allowable (sum of tentative credits, since such sum is within the limitation under section 131 (b) (2))	5,096.80

Example (3): The net income for the calendar year 1938 and the income and profits taxes paid or accrued to foreign countries and possessions of the United States in the case of a domestic corporation were as follows:

Country	Net income	Loss	Income and profits taxes (paid or accrued)
United States	$200,000		
Great Britain	30,000		$7,500
Canada	20,000		1,800
Brazil	40,000		2,400
Argentine Republic	60,000		None.
Mexico		$100,000	None.
Puerto Rico	10,000		1,200
France (dividend)	50,000		[1]10,000
France (branch)	20,000		3,000

[1] Withheld.

Entire net income	$330,000
Total foreign net income	130,000
United States tax before allowance of credit for foreign taxes	48,340

The income and losses from all foreign countries and possessions of the United States, except the dividend from sources within France, were derived from branch operations. Dividends of $50,000 were received from a French corporation, a majority of the voting stock of which was owned by the domestic corporation. The French corporation paid to France income and profits taxes on income earned by it and in addition a dividend tax for the account of its shareholders on income distributed to them, the latter tax being withheld and paid at the source.

The computation of the credit is as follows:

Great Britain

Income and profits taxes paid or accrued	$7,500.00
Limitation under section 131 (b) (1) $\left(\frac{30,000}{330,000} \text{ of } \$48,340\right)$	4,394.55
Tentative credit	4,394.55

Canada

Income and profits taxes paid or accrued	$1,800.00
Limitation under section 131 (b) (1) $\left(\frac{20,000}{330,000} \text{ of } \$48,340\right)$	2,929.70
Tentative credit	1,800.00

Brazil

Income and profits taxes paid or accrued	$2,400.00
Limitation under section 131 (b) (1) $\left(\frac{40,000}{330,000} \text{ of } \$48,340\right)$	5,859.40
Tentative credit	2,400.00

Argentine Republic

Tentative credit	None.

Mexico

Tentative credit	None.

Puerto Rico

Income and profits taxes paid or accrued	$1,250.00
Limitation under section 131 (b) (1) $\left(\frac{10,000}{330,000} \text{ of } \$48,340\right)$	1,464.85
Tentative credit	1,250.00

France

Dividend tax paid at source		$9,000.00
Income and profits taxes paid or accrued on branch operations		3,000.00
Income and profits taxes deemed under section 131 (f) to have been paid, computed as follows:		
Dividend received on December 31 of the taxable year	$50,000.00	
Income of French corporation earned during taxable year	200,000.00	
Income and profits taxes paid to France on $200,000	30,000.00	
Accumulated profits ($200,000 minus $30,000)	170,000.00	
French taxes applicable to accumulated profits distributed $\left(\frac{50,000}{170,000} \text{ of } \left(\frac{170,000}{200,000} \text{ of } \$30,000\right)\right)$	7,500.00	
Limitation under section 131 (f) $\left(\frac{50,000}{330,000} \text{ of } \$48,340\right)$	7,324.24	
Income and profits taxes deemed to have been paid (French taxes applicable to accumulated profits distributed to domestic corporation, reduced in accordance with the limitation under section 131 (f)		7,324.24
Total income and profits taxes paid or accrued and deemed to have been paid to France		19,324.24
Limitation under section 131 (b) (1) $\left(\frac{70,000}{330,000} \text{ of } \$48,340\right)$		10,253.94
Tentative credit		10,253.94

Sum of Tentative Credits

Great Britain	$4,394.55
Canada	1,800.00
Brazil	2,250.00
Puerto Rico	1,250.00
France	10,253.94
	20,098.49
Limitation on sum of tentative credits under section 131 (b) (2) to determine credit $\left(\frac{130,000}{330,000} \text{ of } \$48,340\right)$	19,043.03
Total amount of credit allowable (sum of tentative credits reduced in accordance with the limitation under section 131 (b) (2))	19,043.03

CHAPTER XXII

Returns and Payment of Tax

Supplement D—Returns and Payment of Tax [Supplementary to Subtitle B, Part V]

SEC. 141. *Consolidated returns of railroad corporations.*—(a) *Privilege to file consolidated returns.*—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to all the regulations under subsection (b) (or, in case such regulations are not prescribed prior to the making of the return, then the regulations prescribed under section 141 (b) of the Revenue Act of 1936 insofar as not inconsistent with this Act) prescribed prior to the making of such return; and the making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(b) *Regulations.*—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be determined, computed, assessed, collected, and adjusted in such manner as clearly to reflect the income and to prevent avoidance of tax liability.

(c) *Computation and payment of tax.*—In any case in which a consolidated return is made the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under subsection (b), (or, in case such regulations are not prescribed prior to the making of the return, then the regulations prescribed under section 141 (b) of the Revenue Act of 1936 insofar as not inconsistent with this Act) prescribed prior to the date on which such return is made.

(d) *Definition of "affiliated group".*—As used in this section an "affiliated group" means one or more chains of corporations connected through stock ownership with a common parent corporation if—

(1) At least 95 per centum of the stock of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations; and

(2) The common parent corporation owns directly at least 95 per centum of the stock of at least one of the other corporations; and

(3) Each of the corporations is either (A) a corporation whose principal business is that of a common carrier by railroad or (B) a corporation the assets of which consist principally of stock in such corporations and which does not itself operate a business other than that of a common carrier by railroad. For the purpose of determining whether the principal business of a corporation is that of a common carrier by railroad, if a common carrier by railroad has leased its railroad properties and such properties are operated as such by another common carrier by railroad, the business of receiving rents for such railroad properties shall be considered as the business of a common carrier by railroad. As used in this paragraph, the term "railroad" includes a street, suburban, or interurban electric railway, or a street or suburban trackless trolley system of transportation, or a street or suburban bus system of transportation operated as part of a street or suburban electric railway or trackless trolley system.

As used in this subsection (except in paragraph (3)) the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(e) *Foreign corporations.*—A foreign corporation shall not be deemed to be affiliated with any other corporation within the meaning of this section.

(f) *China Trade Act Corporations.*—A corporation organized under the China Trade Act, 1922, shall not be deemed to be affiliated with any other corporation within the meaning of this section.

(g) *Corporations deriving income from possessions of United States.*—For the purposes of this section a corporation entitled to the benefits of section 251, by reason of receiving a large percentage of its income from possessions of the United States, shall be treated as a foreign corporation.

(h) *Subsidiary formed to comply with foreign law.*—In the case of a domestic corporation owning or controlling, directly or indirectly, 100 per centum of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this title as a domestic corporation.

(i) *Suspension of running of statute of limitations.*—If a notice under section 272 (a) in respect of a deficiency for any taxable year is mailed to a corporation, the suspension of the running of the statute of limitations, provided in section 277, shall apply in the case of corporations with which such corporation made a consolidated return for such taxable year.

(j) *Receivership cases.*—If the common parent corporation of an affiliated group making a consolidated return would, if filing a separate return, be entitled to the benefits of section 13 (e), the affiliated group shall be entitled to the benefits of such subsection. In all other cases the affiliated group making a consolidated return shall not be entitled to the benefits of such subsection, regardless of the fact that one or more of the corporations in the group are in bankruptcy or in receivership.

(k) *Allocation of income and deductions.*—For allocation of income and deductions of related trades or businesses, see section 45.

ART. 141-1. *Consolidated returns of affiliated corporations for taxable years beginning after December 31, 1937.*—The regulations prescribed under section 141 (b) have been promulgated as Regulations 102 and are applicable to the making, after the promulgation of such regulations, of consolidated returns by affiliated corporations for taxable years beginning after December 31, 1937, and to the determination, computation, assessment, collection, and adjustment of tax liabilities under consolidated returns for such years. For definition of taxable year, see section 48.

ART. 141-2. *Formation of and changes in affiliated group.*—An affiliated group of corporations, within the meaning of section 141, is formed at the time that the common parent corporation becomes the owner directly of at least 95 percent of the stock (as defined by section 141 (d)) of another corporation. A corporation becomes a member of an affiliated group at the time that one or more members of the group become the owners directly of at least 95 percent of its stock. A corporation ceases to be a member of an affiliated group at the time that the aggregate of its stock owned directly by the members of the group becomes less than 95 percent.

ART. 141-3. *Corporation to be included in consolidated returns for taxable years beginning after December 31, 1937.*—The privilege of filing consolidated returns for taxable years beginning after December 31, 1937, is limited to corporations constituting an "affiliated group" as defined in section 141 (d). The Act requires each corporation to be either (1) a corporation whose principal business is that of a "common carrier by railroad" or (2) a corporation whose assets consist principally of stock in such corporations and which does not itself operate a business other than that of a "common carrier by railroad." The term "common carrier by railroad" includes steam and electric railroads, street, suburban, and interurban electric railways, street and suburban trackless trolley systems of transportation, and street or suburban bus systems of transportation operated as a part of street or suburban electric railway or trackless trolley systems, but does not include express, refrigerator, or sleeping car companies. If a "common carrier by railroad" as above defined has leased its railroad properties and such properties are operated as such by another common carrier by railroad, the business of receiving rents for such properties is considered as the business of a common carrier by railroad.

A consolidated return must include every domestic corporation which is a member of the "affiliated group"; but shall not include a foreign corporation (except as provided in section 141 (h); a corporation organized under the China Trade Act, 1922; or a corporation entitled to the benefits of section 251.

ART. 141-4. *Foreign corporations which may be treated as domestic corporations.*—In the case of a domestic corporation owning or controlling, directly or indirectly, the entire capital stock (exclusive of directors' qualifying shares) of a corporation described in section 141 (d) (3) and organized under the laws of Canada or of Mexico and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for taxable years beginning after December 31, 1937, as a domestic corporation. The option to treat such foreign corporation as a domestic corporation must be exercised at the time of making the first consolidated return under the Act, and cannot be exercised at any time thereafter. If the election is exercised to treat such foreign corporation as a domestic corporation it must be included in the consolidated return of the affiliated group of which it is a member for each year for which such group makes or is required to make a consolidated return.

SEC. 142. *Fiduciary returns.*—(a) *Requirement of return.*—Every fiduciary (except a receiver appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for any of the following individuals, estates, or trusts for which he acts, stating specifically the items of gross income thereof and the deductions and credits allowed under this title and such other information for the purpose of carrying out the provisions of this title as the Commissioner with the approval of the Secretary may by regulations prescribe—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,500 or over, if married and living with husband or wife;

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income;

(4) Every estate the net income of which for the taxable year is $1,000 or over;

(5) Every trust the net income of which for the taxable year is $100 or over;

(6) Every estate or trust the gross income of which for the taxable year is $5,000 or over, regardless of the amount of the net income; and

(7) Every estate or trust of which any beneficiary is a nonresident alien.

(b) *Joint fiduciaries.*—Under such regulations as the Commissioner with the approval of the Secretary may prescribe a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides shall be sufficient compliance with the above requirement. Such fiduciary shall make oath (1) that he has sufficient knowledge of the affairs of the individual, estate, or trust for which the return is made, to enable him to make the return, and (2) that the return is, to the best of his knowledge and belief, true and correct.

(c) *Law applicable to fiduciaries.*—Any fiduciary required to make a return under this title shall be subject to all the provisions of law which apply to individuals.

ART. 142-1. *Fiduciary returns.*—Every fiduciary, or at least one of joint fiduciaries, must make a return of income—

(a) For the individual whose income is in his charge, if the gross income of such individual is $5,000 or over, or if the net income of such individual is $1,000 or over if single or if married and not living with husband or wife for any part of the taxable year; or if such individual is married and was living with husband or wife for any part of the taxable year but not at the close of the taxable year and his gross income for the taxable year is $5,000 or over, or his net income is equal to, or in excess of, the credit allowed him by section 25 (b) (1) and (3) (computed without regard to his status as head of a family); or if such individual is married and was living with husband or wife for the entire taxable year and the aggregate gross income of both husband and wife is $5,000 or over, or the aggregate net income of both husband and wife is $2,500 or over; or if such individual is married and was living with husband or wife at the close of the taxable year but not during the entire taxable year and the aggregate gross income of both husband and wife is $5,000 or over, or the aggregate net income of both husband and wife is equal to, or in excess of, the credit allowed them by section 25 (b) (1) and (3) (computed without regard to the status of either of them as head of a family, or

(b) For the estate for which he acts if the net income of such estate is $1,000 or over, as computed under section 162, and for the trust for which he acts if the net income of such trust is $100 or over, as computed under section 162, or if the gross income of the estate or trust is $5,000 or over, regardless of the amount of the net income, or if any beneficiary of such estate or trust is a nonresident alien.

The return in case (a) shall be on Form 1040 or 1040 A. In case (b) a return is required on Form 1041. A copy of the will or trust instrument sworn to by the fiduciary as a true and complete copy in cases in which the gross income of the estate or trust is $5,000 or over, must be filed with the fiduciary return of the estate or trust, together with a statement by the fiduciary indicating the provisions of the will or trust instrument which, in his opinion, determine the extent to which the income of the estate or trust is taxable to the estate or trust, the beneficiaries, or the grantor, respectively. If, however, a copy of the will or trust instrument, or statement relating to the provisions of the will or trust instrument, has once been filed, it need not again be filed if the fiduciary return contains a statement showing when and where it was filed. If the trust instrument is amended in any way after such copy has been filed, a copy of the amendment, together with a statement by the fiduciary, indicating the effect, if any, in his opinion, of such amendment on the extent to which the income of the estate or trust is taxable to the estate or trust, the beneficiaries, or the grantor, respectively, must be filed with the return for the taxable year in which the amendment was made. See article 142-5 for returns in cases where any beneficiary is a nonresident alien. If the net income of a decedent from the beginning of the taxable year to the date of his death was equal to, or in excess of, the credit allowed him by section 25 (b) (1) and (3) (computed without regard to his status as head of a family), or if his gross income for the same period was $5,000 or over, the executor or administrator shall make a return for such decedent. (See article 25-7.)

For information returns required to be made by fiduciaries under section 147, see article 147-1.

As to further duties and liabilities, of fiduciaries, see section 312.

ART. 142-2. *Return by guardian or committee.*—A fiduciary acting as the guardian of a minor, or as the guardian or committee of an insane person, having a net income equal to, or in excess of, the credit allowed such person by section 25 (b) (1) and (3) (computed without regard to the status of the minor or insane person as head of a family), or having a gross income of $5,000 or over, must make a return for such person on Form 1040 or 1040 A and pay the tax, unless in the case of a minor the minor himself makes a return or causes it to be made.

For the purpose of determining the liability of a fiduciary to render a return under the provisions of the preceding paragraph in cases where the minor or the incompetent is married and was living with husband or wife at the close of the taxable year, it is the aggregate gross income or the aggregate net income of both husband and wife which is controlling. (See article 51-1.)

ART. 142-3. *Returns where two trusts.*—In the case of two or more trusts the income of which is taxable to the beneficiaries, which were created by the same person and for which the same trustee acts, the trustee shall make a single return on Form 1041 for all such trusts, notwithstanding that they may arise from different instruments. If, however, one person acts as trustee for trusts created by different persons for the benefit of the same beneficiary, he shall make a return on Form 1041 for each trust separately.

ART. 142-4. *Return by receiver.*—A receiver who stands in the stead of an individual or corporation must render a return of income and pay the tax for his trust, but a receiver of only part of the property of an individual or corporation need not. If the receiver acts for an individual the return shall be on Form 1040 or 1040A. When acting for a corporation a receiver is not treated as a fiduciary, and in such a case the return shall be made as if by the corporation itself. (See section 52.) A receiver in charge of the business of a partnership shall render a return on Form 1065. A receiver of the rents and profits appointed to hold and operate a mortgaged parcel of real estate, but not in control of all the property or business of the mortgagor, and a receiver in partition proceedings, are not required to render returns of income. In general, statutory receivers and common law receivers of all the property or business of an individual or corporation must make returns. (See also sections 147 and 148 (a).)

ART. 142-5. *Return for nonresident alien beneficiary.*—(a) *United States business or office.*—If a citizen or resident fiduciary has the distribution of the income of an estate or trust any beneficiary of which is a nonresident alien engaged in trade or business within the United States or having an office or place of business therein at any time within the taxable year, the fiduciary shall make a return on Form 1040B for such nonresident alien and pay any tax shown thereon to be due. (See sections 143 and 211.) Unless such return is a true and accurate return of the nonresident alien beneficiary's income from all sources within the United States, the benefits of the credits and deductions to which the beneficiary is entitled cannot be obtained in the return filed by the fiduciary. (See sections 215 and 251.) If the beneficiary appoints a person in the United States to act as his agent for the purpose of rendering income tax returns, the fiduciary shall be relieved from the necessity of filing Form 1040B in behalf of the beneficiary and from paying the tax. In such a case the fiduciary shall make a return on Form 1041 and attach thereto a copy of the notice of appointment. If the sole beneficiary of an estate or trust is a nonresident alien engaged in trade or business within the United States or having an office or place of business therein at any time within the taxable year the fiduciary shall make a return on Form 1041, as well as on Form 1040B. If there are two or more such nonresident alien beneficiaries, the fiduciary shall render a return on Form 1041 and also a return on Form 1040B for each nonresident alien beneficiary. (See further article 217-1.)

(b) *No United States business or office.*—A citizen or resident fiduciary having the distribution of the income of an estate or trust will not be required to make a return for any beneficiary of the estate or trust who is a nonresident alien not engaged in trade or business within the United States and not having an office or place of business therein at any time within the taxable year if the entire amount of the tax on the income payable to such beneficiary has been withheld at the source (see sections 143 and 211 (a)). A citizen or resident fiduciary having the distribution of the income of an estate or trust shall make a return on Form 1040 NB-a if a beneficiary, other than a resident of Canada, has gross income for the taxable year of more than $21,600 from the sources specified in section 211 (a), regardless of the amount of tax withheld at the source. If the gross income from such sources is $21,600 or less, the return (if a return is required to be filed) for the beneficiary shall be on Form 1040 NB. If a return is required to be filed for a beneficiary who is a resident of Canada, such return also shall be on Form 1040 NB. If the beneficiary appoints a person in the United States to act as his agent for the purpose of rendering income tax returns, the fiduciary shall be relieved from the necessity of filing a return in behalf of the beneficiary and from paying the tax. In such a case the fiduciary shall make a return on Form 1041 and attach thereto a copy of the notice of appointment. The fiduciary shall make a return on Form 1042 of the tax at 10 percent on the entire amount of the income payable to the beneficiary, except that in the case of a beneficiary, resident of Canada, the rate shall be 5 percent. In addition to such return or returns, the fiduciary shall make a return on Form 1041 for the estate or trust, irrespective of the number of beneficiaries.

ART. 142-6. *Time for filing return upon death, or termination of trust.*—After his appointment and qualification, an executor or administrator may immediately file a return for the decedent without waiting for the close of the taxable year. Upon the completion of the administration of an estate and final accounting, an executor or administrator may immediately file a return of income of the estate for the taxable year in which the administration was closed. Similarly, upon the termination of a trust, the trustee may immediately make a return without waiting for the close of the taxable year. Any income return required to be filed for a decedent covering the taxable year during which the decedent dies, or for the year in which an estate is closed or a trust terminated, is due on the 15th day of the third month following the close of the taxable year during which the decedent dies, the estate is closed, or the trust is terminated, which date shall also be the due date for payment of the tax or the first installment thereof if payment is made under the provisions of section 56 (b). The payment of the tax before the end of the taxable year under such circumstances does not relieve the taxpayer from liability for any additional tax found to be due upon income of the taxable year. (See sections 57 and 272.)

The domiciliary representative is required to include in the return rendered by him as such domiciliary representative the entire income of the estate. Consequently the only return required to be filed by the ancillary representative is on Form 1041, which shall be filed with the collector for his district and shall show the name and address of the domiciliary representative, the amount of gross income received by the ancillary representative, and the deductions to be claimed against such income, including any amount of income properly paid or credited by the ancillary representative to any legatee, heir, or other beneficiary. If the ancillary representative for the estate of a nonresident alien is a citizen or resident of the United States, and the domiciliary representative is a nonresident alien, such ancillary representative is required to render the return otherwise required of the domiciliary representative.

SEC. 143. *Withholding of tax at source.*—(a) *Tax-free covenant bonds.*—(1) *Requirement of withholding.*—In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, issued before January 1, 1934, contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods, if payable to an individual, a partnership, or a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein: *Provided,* That if the liability assumed by the obligor does not exceed 2 per centum of the interest, then the deduction and withholding shall be at the following rates: (A) 10 per centum in the case of a nonresident alien individual (except that such rate shall be reduced, in the case of a resident of a contiguous country, to such rate, not less than 5 per centum, as may be provided by treaty with such country), or of any partnership not engaged in trade or business within the United States and not having any office or place of business therein and composed in whole or in part of nonresident aliens, (B) in the case of such a foreign corporation, 15 per centum, and (C) 2 per centum in the case of other individuals and partnerships: *Provided further,* That if the owners of such obligations are not known to the withholding agent the Commissioner may authorize such deduction and withholding to be at the rate of 2 per centum, or, if the liability assumed by the obligor does not exceed 2 per centum of the interest, then at the rate of 10 per centum.

(2) *Benefit of credits against net income.*—Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interests, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the credits provided in section 25 (b); nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Commissioner under section 215.

(3) *Income of obligor and obligee.*—The obligor shall not be allowed a deduction for the payment of the tax imposed by this title, or any other tax paid pursuant to the tax-free covenant clause, nor shall such tax be included in the gross income of the obligee.

(b) *Nonresident aliens.*—All persons, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States, having the control, receipt, custody, disposal, or payment of interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having an office or place of business therein), dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income (but only to the extent that any of the above items constitutes gross income from sources within the United States), of any nonresident alien individual, or of any partnership not engaged in trade or business within the United States and not having any office or place of business therein and composed in whole or in part of nonresident aliens, shall (except in the cases provided for in subsection (a) of this section and except as otherwise provided in regulations prescribed by the Commissioner under section 215) deduct and withhold from such annual or periodical gains, profits, and income a tax equal to 10 per centum thereof, except that such rate shall be reduced, in the case of a nonresident alien individual a resident of a contiguous country, to such rate (not less than 5 per centum) as may be provided by treaty with such country: *Provided,* That no such deduction or withholding shall be required in the case of dividends paid by a foreign corporation unless (1) such corporation is engaged in trade or business within the United States or has an office or place of business therein, and (2) more than 85 per centum of the gross income of such corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of section 119: *Provided further,* That the Commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent. Under regulations prescribed by the Commissioner, with the approval of the Secretary, there may be exempted from such deduction and withholding the compensation for personal services of nonresident alien individuals who enter and leave the United States at frequent intervals.

(c) *Return and payment.*—Every person required to deduct and withhold any tax under this section shall make return thereof on or before March 15 of each year and shall on or before June 15, in lieu of the time prescribed in section 56, pay the tax to the official of the United States Government authorized to receive it. Every such person is hereby made liable for such tax and is hereby indemnified against the claims and demands of any person for the amount of any payments made in accordance with the provisions of this section.

(d) *Income of recipient.*—Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

(e) *Tax paid by recipient.*—If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be re-collected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

(f) *Refunds and credits.*—Where there has been an overpayment of tax under this section any refund or credit made under the provisions of section 322 shall be made to the withholding agent unless the amount of such tax was actually withheld by the withholding agent.

ART. 143-1. *Withholding tax at source.*—(a) *Withholding in general.*—Withholding of a tax of 10 percent is required in the case of fixed or determinable annual or periodical income paid to a nonresident alien individual (even though such individual is engaged in trade or business within the United States or has an office or place of business therein) or to a nonresident partnership, composed in whole or in part of nonresident alien individuals, except (1) income from sources without the United States, including interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having any office or place of business therein, (2) interest upon bonds or other obligations of a corporation containing a tax-free covenant and issued before January 1, 1934 (but see paragraph (b) of this article), (3) dividends paid by a foreign corporation unless (A) such corporation is engaged in trade or business within the United States or has an office or place of business therein, and (B) more than 85 percent of the gross income of such corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States, as determined under the provisions of section 119, (4) dividends distributed by a corporation organized under the China Trade Act, 1922, to a resident of China, and (5) except that such rate of 10 percent shall be reduced, in the case of a resident of a contiguous country, to such rate, not less than 5 percent, as may be provided by treaty with such country. Under the regulations prescribed pursuant to the tax convention between the United States and Canada, the rate of tax to be withheld at the source has been reduced to 5 percent in the case of residents of Canada. (See page 663 of the Appendix to these regulations.)

The tax must be withheld at the source from the gross amount of any distribution made by a corporation, other than a nontaxable distribution payable in stock or stock rights or a distribution in partial or complete liquidation, without regard to any claim that all or a portion of such distribution is not taxable. Appropriate adjustments, if any, will be made upon the filing of claims for refund.

The tax must be withheld at the crued interest paid in connection with the sale of bonds between interest dates.

A tax of 10 percent must be withheld from interest on bonds or securities not containing a tax-free covenant, or containing a tax-free covenant and issued on or after January 1, 1934, if the owner is unknown to the withholding agent, except where such interest represents income from sources without the United States.

For withholding in the case of income paid to nonresident foreign corporations, see article 144–1.

Resident or domestic fiduciaries are required to deduct the income tax at the source from all fixed or determinable annual or periodical gains, profits, and income of nonresident alien beneficiaries, to the extent that such items constitute gross income from sources within the United States. Bond interest, dividends, or other fixed or determinable annual or periodical income paid to a nonresident alien fiduciary is subject to withholding even though the beneficiaries of the estate or trust are citizens or residents of the United States.

The income of a trust created by a nonresident alien individual and taxable to the grantor under the provisions of section 166 or 167 is subject to withholding even though the beneficiaries of such trust are citizens or residents of the United States, and regardless of whether the beneficiaries are exempt from income tax.

A debtor corporation having an issue of bonds or other similar obligations which appoints a duly authorized agent to act in its behalf under the withholding provisions of the Act, is required to file notice of such appointment with the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., giving the name and address of the agent.

If, in connection with the sale of its property, payment of the bonds or other obligations of a corporation is assumed by the assignee, such assignee, whether an individual, partnership, or corporation, must deduct and withhold such taxes as would be required to be withheld by the assignor had no such sale or transfer been made.

For determining income from sources within the United States, see section 119.

As to who are nonresident alien individuals, see articles 211–2 and 901–8. For classification of foreign corporations, see articles 231–1 and 901–8. As to what partnerships are deemed to be nonresident partnerships, see article 901–8.

For withholding in the case of dividends distributed by a corporation organized under the China Trade Act, 1922, see articles 143–3 and 262–4.

(*b*) *Tax-free covenant bonds issued before January 1, 1934.*—The withholding provisions of section 143 (a) (1) are applicable only to bonds, mortgages, or deeds of trust, or other similar obligations of a corporation which were issued before January 1, 1934, and which contain a tax-free covenant. For the purpose of section 143 (a) (1) bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, are issued when delivered. If a broker or other person acts as selling agent of the obligor the obligation is issued when delivered by the agent to the purchaser. If a broker or other person purchases the obligation outright for the purpose of holding or reselling it, the obligation is issued when delivered to such broker or other person.

In order that the date of issue of bonds, mortgages, or deeds of trust, or other similar obligations of corporations, containing a tax-free covenant may be readily determined by the owner, for the purpose of preparing the ownership certificates required under articles 143–1 to 143–9 the "issuing" or debtor corporation shall indicate, by an appropriate notation, the date of issue or use the phrase, "Issued on or after January 1, 1934," on each such obligation or in a statement accompanying the delivery of such obligation.

In cases where on or after January 1, 1934, the maturity date of bonds or other obligations of a corporation is extended, the bonds or other obligations shall be considered to have been issued on or after January 1, 1934. The interest on such obligations is not subject to the withholding provisions of section 143 (a) but falls within the class of interest described in section 143 (b).

In the case of interest upon bonds or other obligations of a corporation containing a tax-free covenant and issued before January 1, 1934, paid to an individual, a fiduciary or a partnership, whether resident or nonresident, withholding of a tax of 2 percent is required, except that if the liability assumed by the obligor in connection with such a covenant does not exceed 2 percent of the interest, withholding is required at the rate of 10 percent in the case of a nonresident alien, or a nonresident partnership composed in whole or in part of nonresident alien individuals or if the owner is unknown to the withholding agent. The rates of withholding applicable to the interest on bonds or other obligations of a corporation containing a tax-free covenant, and issued before January 1, 1934, are applicable to interest on such obligations issued by a domestic corporation or a resident foreign corporation. However, withholding is not required in the case of interest payments on such bonds or obligations if such interest is not to be treated as income from sources within the United States under section 119 (a) (1) (B) and the payments are made to a nonresident alien or a partnership composed wholly of nonresident aliens. A nonresident foreign corporation having a fiscal or paying agent in the United States is required to withhold a tax of 2 percent upon the interest on its tax-free covenant bonds issued before January 1, 1934, paid to an individual or fiduciary who is a citizen or resident of the United States, or to a partnership any member of which is a citizen or resident, or to an unknown owner.

For withholding in the case of interest upon bonds or other obligations of a corporation containing a tax-free covenant and issued before January 1, 1934, paid to nonresident foreign corporations, see article 144–1.

Bonds issued under a trust deed containing a tax-free covenant are treated as if they contain such a covenant. If neither the bonds nor the trust deeds given by the obligor to secure them contained a tax-free covenant, but the original trust deeds were modified prior to January 1, 1934, by supplemental agreements containing a tax-free covenant executed by the obligor corporation and the trustee, the bonds issued prior to January 1, 1934, are subject to the provisions of section 143 (a), provided appropriate authority existed for the modification of the trust deeds in this manner. The authority must have been contained in the original trust deeds or actually secured from the bondholders.

In the case of corporate bonds or other obligations containing a tax-free covenant, issued before January 1, 1934, the corporation paying a Federal tax, or any part of it, for someone else pursuant to its agreement is not entitled to deduct such payment from its gross income on any ground nor shall the tax so paid be included in the gross income of the bondholder. The amount of the tax may nevertheless be claimed by the bondholder as a credit against the total amount of income tax due in accordance with section 143 (d). The tax withheld at the source upon tax-free covenant bond interest included in the income of an estate or trust and taxable to the beneficiaries thereof (including the grantor of a trust subject to section 166 or 167) is allowable, pro rata, as a credit against (1) the tax required to be withheld by the fiduciary from the income of nonresident alien beneficiaries and (2) against the total tax computed in the returns of the beneficiaries required to make returns. In the case, however, of corporate bonds or other obligations containing an appropriate tax-free covenant, the corporation paying for some one else, pursuant to its agreement, a State tax or any tax other than a Federal tax may deduct such payment as interest paid on indebtedness.

ART. 143–2. *Fixed or determinable annual or periodical income.*—Only fixed or determinable annual or periodical income is subject to withholding. The Act specifically includes in such income, interest, dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations and emoluments. But other kinds of income are included, as, for instance, royalties.

Income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals. That the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not make the payments any the less determinable or periodical. A salesman working by the month for a commission on sales which is paid or credited monthly receives determinable periodical income. The share of the income of an estate or trust from sources within the United States which is distributable, whether distributed or not, or which has been paid or credited during the taxable year to a nonresident alien beneficiary of such estate or trust constitutes fixed or determinable annual or periodical income within the meaning of section 143 (b). The income derived from the sale in the United States of property, whether real or personal, is not fixed or determinable annual or periodical income. Such items as taxes, interest on mortgages, or premiums on insurance paid to or for the account of a nonresident alien landlord by a tenant, pursuant to the terms of the lease, constitute fixed or determinable annual or periodical income.

ART. 143-3. *Exemption from withholding.*—Withholding from interest on bonds or other obligations of corporations issued prior to January 1, 1934, containing a tax-free covenant shall not be required in the case of a citizen or resident if he files with the witholding agent when presenting interest coupons for payment, or not later than February 1 of the following year, an ownership certificate on Form 1000 stating that his net income does not exceed his personal exemption and credit for dependents. To avoid inconvenience a resident alien should file a certificate of residence on Form 1078 with withholding agents, who shall forward such certificates to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., with a letter of transmittal.

The income of domestic corporations and of resident foreign corporations is free from withholding.

No withholding from dividends paid by a corporation organized under the China Trade Act, 1922, is required unless the dividends are treated as income from sources within the United States under section 119 and are distributed to—

(1) A nonresident alien other than a resident of China at the time of such distribution;

(2) A nonresident partnership composed in whole or in part of nonresident aliens (other than a partnership resident in China); or

(3) A nonresident foreign corporation (other than a corporation resident in China).

The salary or other compensation for personal services of a nonresident alien individual who enters and leaves the United States at frequent intervals, shall not be subject to deduction and withholding of income tax at the source, provided he is a resident of Canada or Mexico.

The following items of fixed or determinable annual or periodical income from sources within the United States received by a citizen of France residing in France, or a corporation organized under the laws of France, are not subject to the withholding provisions of the Revenue Act of 1938, since such income is exempt from Federal income tax under the provisions of the tax convention between the United States and France, signed April 27, 1932, and effective January 1, 1936 (see page 680 of the Appendix to these regulations):

(1) Amounts paid as consideration for the right to use patents, secret processes and formulas, trade-marks, and other analogous rights;

(2) Income received as copyright royalties; and

(3) Private pensions and life annuities.

The person paying such income should be notified by letter from the French citizen or corporation, as the case may be, that the income is exempt from taxation under the provisions of the convention and protocol referred to above. Such letter from a citizen of France shall contain his address and a statement that he is a citizen of France residing in France. The letter from such corporation shall contain the address of its office or place of business and a statement that it is a corporation organized under the laws of the Republic of France, and shall be signed by an officer of the corporation giving his official title. The letter of notification or a copy thereof should be immediately forwarded by the recipient to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C.

A nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein at any time within the taxable year is subject to the tax imposed by section 211 (a) on gross income and is not entitled to any personal exemption or credit for dependents. Although a nonresident alien individual who is engaged in trade or business within the United States or has an office or place of business therein is entitled to the personal exemption of $1,000 (and a credit for dependents if he is a resident of Canada or Mexico), he is subject to the normal tax and the surtax imposed by sections 11 and 12 of the Act by reason of the provisions of section 211 (b) and the benefit of the personal exemption and credit for dependents may not be received by filing a claim therefor with the withholding agent.

ART. 143-4. *Ownership certificates for bond interest.*—In accordance with the provisions of section 147 (b), citizens and resident individuals and fiduciaries, resident partnerships and nonresident partnerships all of the members of which are citizens or residents, owning bonds, mortgages, or deeds of trust, or other similar obligations issued by a domestic corporation, a resident foreign corporation, or a nonresident foreign corporation having a fiscal agent or a paying agent in the United States, when presenting interest coupons for payment shall file ownership certificates for each issue of such obligations regardless of the amount of the coupons.

In the case of interest payments on overdue coupon bonds, the interest coupons of which have been exhausted, ownership certificates are required to be filed when collecting the interest in the same manner as if interest coupons were presented for collection.

In all cases where the owner of bonds, mortgages, or deeds of trust, or other similar obligations of a corporation is a nonresident alien, a nonresident partnership composed in whole or in part of nonresident aliens, a nonresident foreign corporation, or where the owner is unknown, an ownership certificate for each issue of such obligations shall be filed when interest coupons for any amount are presented for payment. The ownership certificate is required whether or not the obligation contains a tax-free covenant. However, ownership certificates need not be filed by a nonresident alien, a partnership composed wholly of nonresident aliens, or a nonresident foreign corporation in connection with interest payments on such bonds, mortgages, or deeds of trust or other similar obligations of a domestic or resident foreign corporation qualifying under section 119 (a) (1) (B), or of a nonresident foreign corporation.

The ownership certificate shall show the name and address of the debtor corporation, the name and address of the owner of the obligations, a description of the obligations, the amount of interest and its due date, the rate at which tax is to be withheld, and the date upon which the interest coupons were presented for payment.

Ownership certificates need not be filed in the case of interest payments on obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States; or the obligations of the United States or its possessions. (See section 22 (b) (4).) Ownership certificates are not required to be filed in connection with interest payments on bonds, mortgages, or deeds of trust, or other similar obligations issued by an individual or a partnership. Ownership certificates are not required where the owner is a domestic corporation, a resident foreign corporation, or a foreign government.

When interest coupons detached from corporate bonds are received unaccompanied by ownership certificates, unless the owner of the bonds is known to the first bank to which the coupons are presented for payment, and the bank is satisfied that the owner is a person who is not required to file an ownership certificate, the bank shall require of the payee a statement showing the name and address of the person from whom the coupons were received by the payee, and alleging that the owner of the bonds is unknown to the payee. Such statement shall be forwarded to the Commissioner with the monthly return on Form 1012. The bank shall also require the payee to prepare a certificate on Form 1001, crossing out "owner" and inserting "payee" and entering the amount of the interest on line 3, and shall stamp or write across the face of the certificate "Statement furnished," adding the name of the bank.

Ownership certificates are required in connection with interest payments on registered bonds as in the case of coupon bonds, except that if ownership certificates are not furnished by the owner of such bonds, ownership certificates must be prepared by the withholding agent.

ART. 143-5. *Form of certificate for citizens or residents.*—For the purpose of article 143-4, Form 1000 shall be used in preparing ownership certificates of citizens or residents of the United States (individual or fiduciary), resident partnerships, and nonresident partnerships all of the members of which are citizens or residents. If the obligations are issued by a nonresident foreign corporation having a fiscal or paying agent in the United States, Form 1000 should be modified to show the name and address of the fiscal agent or the paying agent in addition to the name and address of the debtor corporation.

ART. 143-6. *Form of certificate for nonresident aliens, nonresident foreign corporations, and unknown owners.*—For the purpose of article 143-4, Form 1001 shall be used in preparing ownership certificates (*a*) of nonresident aliens, (*b*) of nonresident partnerships composed in whole or in part of nonresident aliens, (*c*) of nonresident foreign corporations, and (*d*) where the owner is unknown.

ART. 143-7. *Return and payment of tax withheld.*—Every withholding agent shall make on or before March 15 an annual return on Form 1013 of the tax withheld from interest on bonds or other obligations of corporations. This return should be filed with the collector for the district in which the withholding agent is located. The withholding agent shall also make a monthly return on Form 1012 on or before the 20th day of the month following that for which the return is made. The ownership certificates, Forms 1000 and 1001, must be forwarded to the Commissioner with the monthly return. Such of the forms as report interest from which the tax is to be withheld should be listed on the monthly return. While the forms reporting interest from which no tax is to be withheld need not be listed on the return, the number of such forms submitted should be entered in the space provided. If Form 1000 is modified to show the name and address of a fiscal or paying agent in the United States (see article 143-5), Forms 1012 and 1013 should be likewise modified.

Every person required to deduct and withhold any tax from income other than such bond interest shall make an annual return thereof to the collector on or before March 15 on Form 1042, showing the amount of tax required to be withheld from each nonresident alien, nonresident partnership composed in whole or in part of nonresident aliens, or nonresident foreign corporation to which income other than bond interest was paid during the previous taxable year. Form 1042 should be filed with the collector for the district in which the withholding agent is located. Every United States withholding agent shall make and file with the collector, in duplicate, an information return on Form 1042B, for the calendar year 1938 and each subsequent calendar year, in addition to the withholding return on Form 1042, with respect to the items of income from which a tax of only 5 percent was withheld from Canadian addressees. There shall be reported on Form 1042B not only such items of income listed on Form 1042, but also such items of interest listed on monthly returns on Form 1012, including items of interest where the liability for withholding is only 2 percent. In the case of corporations whose addresses are within Canada, only the fixed or determinable annual or periodical income from sources within the United States consisting of dividends should be reported.

In every case the tax withheld must be paid to the collector on or before June 15 of the following year. For penalties and additions to the tax attaching upon failure to make such returns or such payments, see sections 145 and 291.

If a debtor corporation has designated a person to act for it as withholding agent, and such person has not withheld any tax from the income nor received any funds from the debtor corporation to pay the tax which the debtor corporation assumed in connection with its tax-free covenant bonds, such person cannot be held liable for the tax assumed by the debtor corporation merely by reason of such person's appointment as withholding agent. If a duly authorized withholding agent has become insolvent or for any other reason fails to make payment to the collector of internal revenue of money deposited with it by the debtor corporation to pay taxes, or money withheld from bondholders, the debtor corporation is not discharged of its liability under section 143 (a) (1), since the withholding agent is merely the agent of the debtor corporation.

In any case where income is payable in any medium other than money, the withholding agent shall not release the property so received until it has been placed in funds sufficient to enable it to pay over in money the tax required to be withheld with respect to such income.

ART. 143-8. *Ownership certificates in the case of fiduciaries and joint owners.*—If fiduciaries have the control and custody of more than one estate or trust, and such estates and trusts have as assets bonds of corporations and other securities, a certificate of ownership shall be executed for each estate or trust, regardless of the fact that the bonds are of the same issue. The ownership certificate should show the name of the estate or trust, in addition to the name and address of the fiduciary. If bonds are owned jointly by two or more persons, a separate ownership certificate must be executed in behalf of each of the owners.

ART. 143-9. *Return of income from which tax was withheld.*—The entire amount of the income from which the tax was withheld shall be included in gross income in the return required to be made by the recipient of the income without deduction for such payment of the tax but any tax so withheld shall be credited against the total income tax as computed in the taxpayer's return. (See, however, article 142-5.) If the tax is paid by the recipient of the income or by the withholding agent it shall not be re-collected from the other, regardless of the original liability therefor, and in such event no penalty will be asserted against either person for failure to return or pay the tax where no fraud or purpose to evade payment is involved.

Tax withheld at the source upon fixed or determinable annual or periodical income paid to nonresident alien fiduciaries is deemed to have been paid by the persons ultimately liable for the tax upon such income. Accordingly, if a person is subject to the taxes imposed by section 11, 12, 13, or 14 upon any portion of the income of a nonresident alien estate or trust, the part of any tax withheld at the source which is properly allocable to the income so taxed to such person shall be credited against the amount of the income tax computed upon his return, and any excess shall be credited against any income, war profits, or excess-profits tax, or installment thereof, then due from such person, and any balance shall be refunded.

SEC. 144. *Payment of corporation income tax at source.*—In the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 143 a tax equal to 15 per centum thereof, except that in the case of dividends the rate shall be 10 per centum, and except that in the case of corporations organized under the laws of a contiguous country such rate of 10 per centum with respect to dividends shall be reduced to such rate (not less than 5 per centum) as may be provided by treaty with such country; and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section: *Provided*, That in the case of interest described in subsection (a) of that section (relating to tax-free covenant bonds) the deduction and withholding shall be at the rate specified in such subsection.

ART. 144-1. *Withholding in the case of nonresident foreign corporations.*—A tax of 15 percent is required to be withheld in the case of fixed or determinable annual or periodical income paid to a nonresident foreign corporation except (1) income from sources without the United States, including interest on deposits with persons carrying on the banking business paid to such corporation, (2) interest upon bonds or other obligations of a corporation containing a tax-free covenant and issued before January 1, 1934, where the liability assumed by the obligor exceeds 2 percent of the interest, and (3) dividends.

Withholding of a tax at the rate of 2 percent is required in the case of interest paid to a nonresident foreign corporation, upon bonds or other obligations of a corporation issued prior to January 1, 1934, and containing a tax-free covenant, if the liability assumed by the obligor exceeds 2 percent of the interest and the interest is treated as income from sources within the United States.

A tax of 10 percent is required to be withheld from dividends (other than dividends distributed by a corporation organized under the China Trade Act, 1922, to a resident of China) from sources within the United States paid to a nonresident foreign corporation, except that such rate of 10 percent shall be reduced, in the case of corporations organized under the laws of a contiguous country, to such rate (not less than 5 percent) as may be provided by treaty with such country. (See page 668 of the Appendix to these regulations.) Dividends paid by a foreign corporation are not, however, subject to withholding unless such corporation is engaged in trade or business within the United States or has an office or place of business therein and more than 85 percent of the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of section 119. (See also section 143.)

For withholding in the case of dividends distributed by a corporation organized under the China Trade Act, 1922, see articles 143-3 and 262-4.

ART. 144-2. *Aids to withholding agents in determining liability for withholding of tax.*—Since no withholding of tax on bond interest, dividends, or other income is required in the case of a resident foreign corporation (see article 143-3), the person paying such income should be notified by a letter from such corporation that it is not subject to the withholding provisions of the Act. The letter from the corporation shall contain the address of its office or place of business in the United States and be signed by an officer of the corporation giving his official title. Such letter of notification, or copy thereof, should be immediately forwarded by the recipient to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C. The same procedure should be followed in the case of resident partnerships, composed in whole or in part of nonresident aliens, not subject to the withholding provisions of the Act except in the case of interest on tax-free covenant bonds. The letter should be signed by a member of the firm.

When a payor corporation, or any other person (including a nominee), having the control, receipt, custody, disposal, or payment of dividends has no definite knowledge of the status of the shareholder, the tax should be withheld if the shareholder's address is outside the United States. If the shareholder's address is within the United States, it may be assumed that such shareholder is a citizen or a resident thereof. Unless the name and style of the shareholder are such as to indicate clearly that he is a nonresident alien, an address in care of another person in the United States does not of itself warrant the treating of the shareholder as a nonresident alien. If a shareholder changes his address from a place without the United States to a place within the United States, the tax should be withheld unless proof is furnished showing that he is a citizen or a resident of the United States. A person's written statement that he is a citizen, or resident of the United States, may be relied upon by the payor of income as proof that such person is a citizen or resident of the United States.

The following table of withholding rates under the Revenue Act of 1938 and the tax convention between the United States and Canada has been prepared for the purpose of making a summary of such rates readily available to withholding agents:

Classes of taxpayers	Corporate bond interest: With tax-free covenant and issued before Jan. 1, 1934: If corporation assumes over 2 percent of the tax	Corporate bond interest: With tax-free covenant and issued before Jan. 1, 1934: If corporation assumes not over 2 percent of the tax	Corporate bond interest: Without tax-free covenant or issued on or after Jan. 1, 1934, with tax-free covenant	Dividends from domestic corporation	Dividends from foreign corporation mentioned in article 143-1	Salary or other compensation for personal services	Other fixed or determinable annual or periodical income from sources within the United States
	Percent	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
1. Citizen or resident individual, fiduciary, or partnership	2	2					
2. Nonresident individual, fiduciary, or partnership (except as stated in item 5 below)	2	10	10	10	10	[1] 10	10
3. Domestic corporation or resident foreign corporation							
4. Nonresident foreign corporation (except as stated in item 6 below)	2	15	15	10	10	15	15
5. Individual, fiduciary, or partnership, resident of Canada	2	5	5	5	5	([1])	5
6. Nonresident corporation organized under laws of Canada	2	15	15	5	5	15	15
7. Unknown owner	2	10	10				

[1] Salary or compensation for personal services rendered in the United States is not subject to withholding in the case of nonresident aliens, residents of Canada or Mexico, who enter and leave the United States at frequent intervals.

SEC. 145. *Penalties.*—(a) Any person required under this title to pay any tax, or required by law or regulations made under authority thereof to make a return, keep any records, or supply any information, for the purposes of the computation, assessment, or collection of any tax imposed by this title, who willfully fails to pay such tax, make such return, keep such records, or supply such information, at the time or times required by law or regulations, shall, in addition to other penalties provided by law, be guilty of a misdemeanor and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than one year, or both, together with the costs of prosecution.

(b) Any person required under this title to collect, account for, and pay over any tax imposed by this title, who willfully fails to collect or truthfully account for and pay over such tax, and any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof, shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than five years, or both, together with the costs of prosecution.

(c) The term "person" as used in this section includes an officer or employee of a corporation or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

(d) For penalties for failure to file information returns with respect to foreign personal holding companies and foreign corporations, see section 340.

ART. 145-1. *Penalties.*—The penalties provided for in section 145 cannot be assessed but are enforceable only by suit or prosecution. For limitations on prosecutions, see the Act of July 5, 1884, as amended by section 1103 of the Revenue Act of 1932 (paragraph 51 of the Appendix to these regulations). The willful failure of a taxpayer to give information required in his return as to advice or assistance rendered in the preparation of the return, and the willful failure of the person preparing a return for another to execute the sworn statement required with reference thereto, make such persons subject to the penalties imposed by section 145 (a). The privilege against incrimination in the fifth amendment to the Constitution is not a defense to a charge of failure to file a return, and does not authorize a refusal to state the amount of income, though the taxpayer's income was made through crime.

SEC. 146. *Closing by commissioner of taxable year.*—(a) *Tax in jeopardy.*—(1) *Departure of taxpayer or removal of property from United States.*—If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of such tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any proceeding in court brought to enforce payment of taxes made due and payable by virtue of the provisions of this section the finding of the Commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design.

(2) *Corporation in liquidation.*—If the Commissioner finds that the collection of the tax of a corporation for the current or last preceding taxable year will be jeopardized by the distribution of all or a portion of the assets of such corporation in the liquidation of the whole or any part of its capital stock, the Commissioner shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the last preceding taxable year or so much of such tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable.

(b) *Security for payment.*—A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any Act of Congress may furnish to the United States, under regulations to be prescribed by the Commissioner, with the approval of the Secretary, security approved by the Commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this section, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him under any Act of Congress.

(c) *Same—Exemption from section.*—If security is approved and accepted pursuant to the provisions of this section and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any proceedings under the provisions of this section prior to the expiration of the time otherwise allowed for paying such respective taxes.

(d) *Citizens.*—In the case of a citizen of the United States or of a possession of the United States about to depart from the United States the Commissioner may, at his discretion, waive any or all of the requirements placed on the taxpayer by this section.

(e) *Departure of alien.*—No alien shall depart from the United States unless he first procures from the collector or agent in charge a certificate that he has complied with all the obligations imposed upon him by the income, war-profits, and excess-profits tax laws.

(f) *Addition to tax.*—If a taxpayer violates or attempts to violate this section there shall, in addition to all other penalties, be added as part of the tax 25 per centum of the total amount of the tax or deficiency in the tax, together with interest at the rate of 6 per centum per annum from the time the tax became due.

ART. 146–1. *Termination of the taxable period by Commissioner.*—(a) Section 146 provides that in the case of a taxpayer who designs by immediate departure from the United States or otherwise to avoid the payment of the tax for the preceding or current taxable year, the Commissioner may upon evidence satisfactory to him, declare the taxable period for such taxpayer immediately terminated and cause to be served upon him notice and demand for immediate payment of the tax for the taxable period declared terminated, and of the tax for the preceding taxable year, or so much of such tax as is unpaid. In such a case the taxpayer is entitled to the personal exemption and credit for dependents, if otherwise allowable, but the amount allowable as personal exemption and credit for dependents shall be reduced proportionately to the length of the period for which the return is made. If suit is necessary to collect a tax made due and payable by the provisions of section 146 (a) (1), the Commissioner's finding is presumptive evidence of the taxpayer's design. Section 146 (a) (2) provides for a similar termination of the taxable period of a corporation if the Commissioner finds that the collection of the tax of the corporation for the current or last preceding taxable year will be jeopardized by the distribution of all or a portion of the assets of such corporation in the liquidation of the whole or any part of its capital stock. Such finding of the Commissioner is considered prima facie correct. A taxpayer who is not in default in making the returns or in paying other taxes may procure the postponement until the usual time of the payment of taxes which are or may be due pursuant to this article by depositing with the Commissioner United States bonds of a principal amount not exceeding double the amount of taxes due for the taxable period, or by furnishing such other security as may be approved by the Commissioner.

(b) Except as provided in paragraph (c) of this article an alien who intends to depart from the United States will be required to file a return of income on Form 1040C and to obtain a certificate of compliance with income tax obligations from the collector or internal revenue agent in charge. A certificate of compliance is attached to and made a part of Form 1040C. An alien, whether resident or nonresident, who intends to depart from the United States should appear before the collector or internal revenue agent in charge for the district in which he resides and satisfy all income tax obligations with respect to income received or to be received, determined as nearly as may be, up to and including the date of his intended departure. Upon payment of such obligations, or upon the furnishing of such security as may be approved by the Commissioner for the payment of such obligations, or upon satisfactory evidence that no tax is due and payable, the collector or internal revenue agent in charge will issue a certificate of compliance to the applicant. A properly executed certificate of compliance issued by the collector or internal revenue agent must be presented at the point of departure. An alien presenting himself at the point of departure without such certificate of compliance will be examined by an internal revenue officer at that point and such taxes as appear to be due and owing will be collected. Citizens of the United States or of possessions of the United States departing from the United States will not be required to procure certificates of compliance or to present any other evidence of compliance with income tax obligations.

(c) An alien who intends to depart from the United States and whose taxable year has not been terminated by the Commissioner as provided in section 146 (a), and who is not in default in making any return, or paying income, war-profits, or excess-profits tax under any Act of Congress, may procure a certificate of compliance as provided in section 146 (e) by (1) appointing in writing on Form 934 an attorney in fact, resident in the United States, to make his income tax return or returns for the taxable year current at the time of his intended departure and for the next preceding taxable year (if not already made), (2) making on Form 1040D a return of information for his taxable year current at the time of his intended departure and a return on that form for the next preceding taxable year where the period for making the income tax return for the next preceding taxable year has not expired, and (3) either paying the estimated tax as shown on the information return (Form 1040D), which will be credited on account for the year covered by such return, or furnishing security approved by the Commissioner that he will make the required return or returns and pay the tax or taxes required to be paid. If such security is approved and accepted and such further security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes may be postponed until the expiration of the time otherwise allowed for their payment. The departing alien may furnish as security a surety bond on Form 1133 in an amount not exceeding double the amount of tax for his taxable year current at the time of his intended departure, and for the next preceding taxable year (if not already paid), conditioned upon the making of his return or returns for such year or years (if not already made), and the payment of any tax or taxes that may become payable for such year or years together with any penalty and interest that may accrue thereon, such bond to be executed by a surety or sureties approved by the Commissioner. In lieu of such a surety bond, the taxpayer may furnish as security a penal bond (Form 1133), approved by the Commissioner, secured by deposit of bonds or notes of the United States equal in their total par value to an amount not exceeding double the amount of the tax or taxes in respect of which the bond is furnished. A form of a "certificate of compliance" is made a part of Form 1040D. Bonds complying with the provisions of this article, if properly executed and with adequate surety, are approved, and may be accepted in the name of the Commissioner, by the collector or internal revenue agent in charge by signing the Form 1133 as follows:

____
Commissioner of Internal Revenue.
By ________________________________
(*Collector of Internal Revenue.*)
____
(*Internal Revenue Agent in Charge.*)

A corporation will not be accepted as a surety on such bond unless the corporation holds a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds. If the surety on the bond is an individual or individuals such bond shall not be accepted until an investigation is made as to the financial and other responsibility of such surety or sureties and such investigation shows that the collection of the tax is amply secured by the bond.

SEC. 147. *Information at source.*—(a) *Payments of $1,000 or more.*—All persons, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another person, of interest, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments described in section 148 (a) or 149), of $1,000 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

(b) *Returns regardless of amount of payment.*—Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by persons undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange.

(c) *Recipient to furnish name and address.*—When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the person paying the income.

(d) *Obligations of United States.*—The provisions of this section shall ont apply to the payment of interest on obligations of the United States.

ART. 147-1. *Return of information as to payments of $1,000.*—All persons making payment to another person of fixed or determinable income of $1,000 or more in any calendar year must render a return thereof to the Commissioner for such year on or before February 15 of the following year, except as specified in articles 147-3 to 147-5. A return shall be made in each case on Form 1099, accompanied by transmittal Form 1096 showing the number of returns filed, except that the return with respect to distributions to beneficiaries of a trust or of an estate shall be made on Form 1041 in lieu of Forms 1099 and 1096. The street and number where the recipient of the payment lives should be stated, if possible. If no present address is available, the last known post-office address must be given. Although to make necessary a return of information the income must be fixed or determinable, it need not be annual or periodical. (See article 143-2.)

Sums paid in respect of life insurance, endowment or annuity contracts which are required to be included in gross income under articles 22 (b) (1)-1, 22 (b) (2)-1, and 22 (b) (2)-2 come within the meaning of the term "fixed or determinable income" and are required to be reported in returns of information as required by this article, except that payments in respect of policies surrendered before maturity and lapsed policies need not be reported.

Fees for professional services paid to attorneys, physicians, and members of other professions come within the meaning of the term "fixed or determinable income" and are required to be reported in returns of information as required by this article.

For the purposes of a return of information, an amount is deemed to have been paid when it is credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and which is made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.

ART. 147-2. *Return of information as to payments to employees.*—The names of all employees to whom payments of $1,000 or over a year are made, whether such total sum is made up of wages, salaries, commissions, or compensation in any other form, must be reported. Heads of branch offices and subcontractors employing labor, who keep the only complete record of payments therefor, should file returns of information in regard to such payments directly with the Commissioner. When both main office and branch office have adequate records, the return should be filed by the main office. Amounts distributed or made available under an employees' trust governed by the provisions of section 165 to any beneficiary in any taxable year, in excess of the sum of his personal exemption and the amounts paid into the fund by him, must be reported by the trustee. But see article 147-3. (See also article 22 (a)-3.)

In the case of payments made by the United States to persons in its service (civil, military, or naval) of wages, salaries, or compensation in any other form, the returns of information shall be made by the heads of the executive departments and other United States Government establishments.

ART. 147-3. *Cases where no return of information required.*—Payments of the following character, although over $1,000, need not be reported in returns of information on Form 1099:

(a) Payments of interest on obligations of the United States;

(b) Payments by a broker to his customers;

(c) Payments of any type made to corporations;

(d) Bills paid for merchandise, telegrams, telephone, freight, storage, and similar charges;

(e) Payments of rent made to real estate agents (but the agent must report payments to the landlord if the amount paid during the year was $1,000 or more);

(f) Payments made to alien employees serving in foreign countries or payments representing earned income for services rendered without the United States made to nonresident citizens entitled to the benefits of section 116 (a);

(g) Salaries and profits paid or distributed by a partnership to the individual partners;

(h) Payments of salaries, or other compensation for personal services aggregating less than $2,500 made to a married individual (citizen or resident);

(i) Payments of commissions made by fire insurance companies, or other companies insuring property, to general agents, except when specifically directed by the Commissioner to be filed;

(j) Payments of income upon which income tax has been withheld at the source and reported on Forms 1012, 1013, or 1042; and

(k) Amounts paid by the United States to persons in its service (civil, military, or naval) as an allowance for traveling expenses, including an allowance for meals and lodging, as, for example, a per diem allowance in lieu of subsistence, and amounts paid as reimbursements for traveling expenses.

If the marital status of the payee is unknown to the payor, or if the marital status of the payee changed during the year (see article 25-7), or if the payee is a resident of Canada or Mexico, the payee will be considered a single person for the purpose of filing a return of information on Form 1099 with respect to payments of salaries or other compensation for personal services.

ART. 147-4. *Return of information as to interest on corporate bonds.*—In the case of payments of interest, regardless of amount, upon bonds and similar obligations of corporations, the ownership certificates, when duly filed, shall constitute and be treated as returns of information. (See article 143-5.)

ART. 147-5. *Return of information as to payments to other than citizens or residents.*—In the case of payments of fixed or determinable annual or periodical income to nonresident aliens (individual or fiduciary), to nonresident partnerships composed in whole or in part of nonresident aliens, or to nonresident foreign corporations (see article 901-8), the returns filed by withholding agents on Form 1042 shall constitute and be treated as returns of information. (See sections 143 and 144.)

ART. 147-6. *Foreign items.*—The term "foreign items," as used in these regulations, means any item of interest upon the bonds of a foreign country or of a nonresident foreign corporation not having a fiscal or paying agent in the United States, or any item of dividends upon the stock of such corporation.

ART. 147-7. *Return of information as to foreign items.*—In the case of foreign items, an information return on Form 1099 is required to be filed by the bank or collecting agent accepting the items for collection, if the foreign item is paid to a citizen or resident of the United States (individual or fiduciary), or a partnership any member of which is a citizen or resident, and if the amount of the foreign items paid in any taxable year to an individual, a partnership, or a fiduciary is $1,000 or more. Such forms accompanied by Form 1096 should be forwarded to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., on or before February 15 of each year. The term "collection" includes the following: (*a*) The payment by the licensee of the foreign item in cash; (*b*) the crediting by the licensee of the account of the person presenting the foreign item; (*c*) the tentative crediting by the licensee of the account of the person presenting the foreign item until the amount of the foreign item is received by the licensee from abroad; and (*d*) the receipt of foreign items by the licensee for the purpose of transmitting them abroad for deposits. (See articles 147-1 and 147-3.)

ART. 147-8. *Information as to actual owner.*—When the person receiving a payment falling within the provisions of the Act for information at the source is not the actual owner of the income received, the name and address of the actual owner or payee shall be furnished upon demand of the individual, corporation, or partnership paying the income, and in default of a compliance with such demand the payee becomes liable for the penalties provided. (See section 145.) Dividends on stock are prima facie the income of the record owner of the stock. Upon receipt of dividends by a record owner, he should execute Form 1087 to disclose the name and address of the actual owner or payee. Form 1087 should be filed with the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., not later than February 15 of the succeeding year. Unless such a disclosure is made, the record owner will be held liable for any tax based upon such dividends. (See article 148-1.)

The filing of Form 1087 is not required (*a*) if the record owner is required to file a fiduciary return on Form 1041, or a withholding return on Form 1042, disclosing the name and address of the actual owner or payee, or (*b*) if the actual owner or payee is a nonresident alien individual, foreign partnership, or foreign corporation and the 10 percent tax has been withheld at the source prior to receipt of the dividends by the record owner. (See article 143-1.)

SEC. 148. *Information by corporations.*—(*a*) *Dividend payments.*—Every corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each shareholder, the number of shares owned by him, and the amount of dividends paid to him.

(*b*) *Profits declared as dividends.*—Every corporation shall, when required by the Commissioner, furnish him a statement of such facts as will enable him to determine the portion of the earnings or profits of the corporation (including gains, profits, and income not taxed) accumulated during such periods as the Commissioner may specify, which have been distributed or ordered to be distributed, respectively, to its shareholders during such taxable years as the Commissioner may specify.

(*c*) *Accumulated earnings and profits.*—When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of accumulated earnings and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

(*d*) *Contemplated dissolution or liquidation.*—Every corporation shall, within thirty days after the adoption by the corporation of a resolution or plan for the dissolution of the corporation or for the liquidation of the whole or any part of its capital stock, render a correct return to the Commissioner, verified under oath, setting forth the terms of such resolution or plan and such other information as the Commissioner shall, with the approval of the Secretary, by regulations prescribe.

(*e*) *Distributions in liquidation.*—Every corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its distributions in liquidation, stating the name and address of each shareholder, the number and class of shares owned by him, and the amount paid to him or, if the distribution is in property other than money, the fair market value (as of the date the distribution is made) of the property distributed to him.

(*f*) *Compensation of officers and employees.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, every corporation subject to taxation under this title shall, in its return, submit a list of the names of all officers and employees of such corporation and the respective amounts paid to them during the taxable year of the corporation by the corporation as salary, commission, bonus, or other compensation for personal services rendered, if the aggregate amount so paid to the individual is in excess of $75,000. The Secretary of the Treasury shall compile from the returns made a list containing the names of, and the amounts paid to, each such officer and employee and the name of the paying corporation, and shall make such list available to the public.

ART. 148-1. *Return of information as to payments of dividends.*—Section 148 provides that every corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each shareholder, the number of shares owned by him, and the amount of dividends paid to him. In accordance with that section, returns of information in respect of dividend payments shall be rendered for each calendar year as follows:

(*a*) Except as provided in paragraph (*b*) below, every domestic corporation or foreign corporation engaged in business within the United States or having an office or place of business or a fiscal or paying agent in the United States, making payments of dividends and distributions (other than distributions in liquidation) (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year) without regard to the amount of the earnings and profits at the time the distribution was made, to any shareholder who is an individual (citizen or resident of the United States), a resident fiduciary, or a resident partnership any member of which is a citizen or resident, amounting to $100 or more during each calendar year, shall render an information return on Forms 1096 and 1099. A separate Form 1099 must be prepared for each shareholder, upon which will be shown the name and address of the shareholder to whom such payment was made, and the amount paid. These forms, accompanied by a letter of transmittal on Form 1096 showing the number of Forms 1099 filed therewith, shall be filed with the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., on or before February 15 of the following year.

The periodical distributions of earning on running installment shares of stock paid or credited by a building and loan association to its holders of that class of stock are dividends within the meaning of section 115 (a). The sum received upon withdrawal from a building and loan association in excess of the amounts paid in on account of membership fees and stock subscriptions, consisting of accumulated profits, constitutes a dividend within the meaning of section 115 (a). As to when a stock dividend is taxable as a dividend see section 115 (f).

(*b*) In cases of distributions which are made from a depletion or depreciation reserve, or which for any other reason are deemed by the corporation to be nontaxable or partly nontaxable to its shareholders, the corporation will first fill in the information on the reverse side of Form 1096 and forward this form to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., not later than February 1 of the following year. Upon receipt of this information the Commissioner will determine and advise the corporation by letter whether any portion of such distribution is subject to tax. The corporation after receiving this letter will then properly prepare for each shareholder a Form 1099, which shall be forwarded with Form 1096 to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., not later than 30 days after such letter is received.

In any case in which it is impossible to file the return within the time prescribed in this article, the corporation may, upon a showing of such fact, obtain a reasonable extension of time for filing the return. The request for the extension of time must be forwarded to the Commissioner of Internal Revenue, Practice and Procedure Division, Washington, D. C., on or before the date prescribed for filing the return.

ART. 148–2. *Return of information respecting contemplated dissolution or liquidation*—(*a*) *Making and filing of returns.*—Within 30 days after the adoption on or after May 28, 1938, of any resolution or plan for or in respect of the dissolution of a corporation or the liquidation of the whole or any part of its capital stock, the corporation shall file with the Commissioner of Internal Revenue, Washington, D. C., attention of the Income Tax Unit, Records Division, a correct return on Form 966, made under oath or affirmation and containing the information required by paragraph (*b*) of this article and by such form. A like return shall be filed by the corporation in the case of any amendment of, or supplement to, a resolution or plan for or in respect of the dissolution of the corporation or the liquidation of the whole or any part of its capital stock adopted on, before, or after May 28, 1938, if such amendment or supplement was adopted on or after May 28, 1938. A return must be filed under section 148 (d) in respect of a liquidation whether or not any part of the gain or loss to the shareholders upon the liquidation is recognized under the provisions of section 112.

(*b*) *Contents of return.*—(1) *General.*—There shall be attached to and made a part of the return required by section 148 (d) and paragraph (*a*) of this article a certified copy of the resolution or plan, together with any amendments thereof or supplements thereto, and such return shall in addition contain the following information:

(i) The name and address of the corporation;

(ii) The place and date of incorporation;

(iii) The date of the adoption of the resolution or plan and the dates of any amendments thereof or supplements thereto; and

(iv) The collection district in which the last income tax return of the corporation was filed and the taxable year covered thereby.

(2) *Liquidation in December, 1938.*—In the event that the corporation is a domestic corporation and the plan of liquidation (adopted after May 28, 1938) provides for a distribution in complete cancellation or redemption of all the capital stock of the corporation, and for the transfer of all the property of the corporation under the liquidation entirely within the month of December, 1938, such return shall, in addition to the information required by paragraph (*b*) (1) of this article, contain the following information:

(i) A statement showing the number of shares of each class of stock outstanding on the date of the adoption of the plan of liquidation, together with a description of the voting power of each such class;

(ii) A list of all the shareholders owning stock on the date of the adoption of the plan of liquidation, together with the number of shares of each class of stock owned by each shareholder, the certificate numbers thereof, and the total number of votes to which entitled on the adoption of the plan of liquidation; and

(iii) A list of all corporate shareholders as of April 9, 1938, together with the number of shares of each class of stock owned by each such shareholder, the certificate numbers thereof, the total number of votes to which entitled on the adoption of the plan of liquidation, and a statement of all changes in ownership of stock by corporate shareholders between April 9, 1938, and the date of the adoption of the plan of liquidation, both dates inclusive.

(3) *Returns in respect of amendments or supplements.*—If a return in respect of any resolution or plan for or in respect of the dissolution of a corporation or the liquidation of the whole or any part of its capital stock has already been filed pursuant to section 148 (d), a return in respect of any amendment thereof or supplement thereto will be deemed sufficient if it gives the date such prior return was filed and contains a duly certified copy of such amendment or supplement and all other information required by this article and by Form 966 which was not given in such prior return. If no return was filed relative to the resolution or plan which is being amended or supplemented, the return relative to the amendment thereof or supplement thereto shall contain a duly certified copy of the resolution or plan which is being amended or supplemented, together with all amendments thereof and supplements thereto, and all other information required by this article and by Form 966.

ART. 148–3. *Return of information respecting distributions in liquidation.*—Unless the distribution is one in respect of which information is required to be filed pursuant to article 112 (b) (6)–5 (b), 112 (g)–6 (a), or 371–10, every corporation making any distribution in liquidation of the whole or any part of its capital stock shall file a return of information on Forms 1096 and 1099L, giving all the information required by such forms and by these regulations. A separate Form 1099L must be prepared in duplicate for each shareholder to whom such distribution was made, showing the name and address of such shareholder, the number and class of shares owned by him in liquidation of which such distribution was made, and the total amount distributed to him on each class of stock. If the amount distributed to such shareholder on any class of stock consisted in whole or in part of property other than money, the return on such form shall in addition show the amount of money distributed, if any, and shall list separately each class of property other than money distributed, giving a description of the property in each such class and a statement of its fair market value at the time of the distribution.

Such duplicate forms, accompanied by a letter of transmittal on Form 1096 showing the number of Forms 1099L filed therewith, shall be filed with the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., on or before February 15 of the year following the calendar year in which such distribution was made. If the distribution is in complete liquidation of a domestic corporation pursuant to a plan of liquidation adopted after May 28, 1938, in accordance with which all the capital stock of the corporation is canceled or redeemed and the transfer of all the property under the liquidation occurs in the month of December, 1938, the return on Form 1096 shall show (1) the amount of earnings and profits of the corporation accumulated after February 28, 1913, determined as of December 31, 1938, but without diminution by reason of distributions made during the month of December, 1938, (2) the ratable share of such earnings and profits of each share of stock canceled or redeemed in the liquidation, and (3) the date and circumstances of the acquisition by the corporation of any stock or securities distributed to shareholders in the liquidation.

ART. 148–4. *Information respecting compensation of officers and employees in excess of $75,000.*—Every corporation subject to taxation under Title I which during any taxable year beginning on or after January 1, 1938, has paid to any officer or employee of the corporation, salary, commission, bonus, or other compensation for personal services rendered, in an aggregate amount in excess of $75,000 (in whatever form paid), shall in respect of each such taxable year, make and file, in duplicate, Schedule H-1, as a part of its income tax return, in accordance with the instructions contained in the prescribed return. Such schedule shall contain the following information: (1) Name of officer or employee, (2) amount of salary paid, (3) amount of commission paid, (4) amount of bonus paid, (5) amount of other compensation paid, and (6) total compensation paid.

The term "paid" as used in this article means "paid or accrued" or "paid or incurred" which shall be construed according to the method of accounting upon the basis of which the net income of the corporation is computed.

Upon receipt of the returns by the collector, the schedules will be detached and forwarded by the collector to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C.

SEC. 149. *Returns of brokers.*—Every person doing business as a broker shall, when required by the Commissioner, render a correct return duly verified under oath, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, showing the names of customers for whom such person has transacted any business, with such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on profits or gains of such customers has been paid.

ART. 149-1. *Return of information by brokers.*—Every person or organization acting as broker or other agent in stock, bond, or commodity transactions (including banks which handle orders for depositors or custodian accounts) is hereby directed to make an annual return of information on Form 1100 for each customer, depositor, or account for whom or which the total amount of either the purchases or sales of securities or commodities, for the customer, or the total market value of the securities exchanged for the customer, is $25,000 or more during the calendar year 1938 and each subsequent calendar year, except as provided in this article or as otherwise specifically directed by the Commissioner. The form shall show the name and address of the customer and the title of the account; the name and address of the broker or agent; the names and addresses of the guarantor of the account and others with power to make withdrawals of cash, securities, or commodities from the account; and, except as provided in the fourth paragraph of this article, the form shall also show the total of the purchases, the total of the sales, and the total market value of the securities exchanged for the customer or account.

The making of Form 1100 by banks and trust companies may be confined to cases involving sales and exchanges for customers aggregating $25,000 or more during the year, and the dollar totals may be omitted from the Form 1100. It is to be understood, however, that such a form shall be made for each case involving sales and exchanges aggregating $25,000 or more during each year.

Banks and trust companies will not be required to file Form 110 covering purchases, sales, or exchanges made by them when acting for themselves or as executor, administrator, trustee, or in any other fiduciary capacity (not including custodian or safe-keeping accounts as fiduciary), or for other banks, trust companies, brokers, or other financial institutions doing business in the United States. Banks and trust companies will not be required to file returns covering purchases and sales where they do not actually give the orders for the purchases and sales.

Brokers and other agents handling purchases and sales of commodities for customers may report on Form 1100 for each year either the total profit or loss of each customer on all of such transactions, when $500 or more, in lieu of the total purchases or sales of $25,000 or more. If the profit or loss is reported a Form 1100 should be prepared for each customer whenever the amount of the total profit or loss of the customer from all such transactions is $500 or more for the calendar year, and the form should be noted accordingly.

Persons or organizations having domestic correspondents will not report on Form 1100 for such domestic correspondents inasmuch as each correspondent will report for his or its individual customers.

Form 1100 is printed on white paper and a duplicate thereof is printed on pink paper. In each case where the account is guaranteed or others have power to make withdrawals of cash, securities, or commodities from the account, a duplicate of the form as prepared on white paper shall be made on the pink form for each name and address, other than the customer, required to be shown on Form 1100.

Form 1100A is provided for use as a letter of transmittal and affidavit to accompany Forms 1100. The Forms 1100 for each year accompanied by Forms 1100A, properly filled out and executed, shall be forwarded to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., not later than February 15, following the close of the calendar year. The forms will be distributed through the collectors of internal revenue for the various collection districts.

Returns made by individuals must be sworn to by the individual or his duly authorized agent. Returns made by corporations, partnerships, and other organizations must be signed and sworn to by an officer or member of the organization.

SEC. 150. *Collection of foreign items.*—All persons undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such regulations enabling the Government to obtain the information required under this title as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000 or imprisoned for not more than one year, or both.

ART. 150-1. *License to collect foreign items.*—Banks or agents collecting foreign items, as defined in article 147-6, and required by article 147-7 to make returns of information with respect thereto, must obtain a license from the Commissioner to engage in such business. Application Form 1017 for such license may be procured from collectors. The license is issued without cost on Form 1010. Any person holding a license under the Revenue Act of 1936 or any prior Act will not be required to renew such license.

SEC. 151. *Foreign personal holding companies.*—For information returns by officers, directors, and large shareholders, with respect to foreign personal holding companies, see sections 338, 339, and 340.

CHAPTER XXIII

Estates and Trusts

Supplement E—Estates and Trusts

SEC. 161. *Imposition of tax.*—(a) *Application of tax.*—The taxes imposed by this title upon individuals shall apply to the income of estates or of any kind of property held in trust, including—

(1) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust;

(2) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(3) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

(4) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

(b) *Computation and payment.*—The tax shall be computed upon the net income of the estate or trust, and shall be paid by the fiduciary, except as provided in section 166 (relating to revocable trusts) and section 167 (relating to income for benefit of the grantor). For return made by fiduciary, see section 142.

ART. 161-1. *Imposition of the tax*—(a) *Scope.*—Supplement E prescribes that the taxes imposed upon individuals by Title I shall be applicable to the income of estates or of any kind of property held in trust. The rate of tax, the statutory provisions respecting gross income, and, with certain exceptions, the deductions and credits allowed to individuals apply also to estates and trusts.

The several classes enumerated and described in the four paragraphs of section 161 (a), and which are introduced by the word "including," do not exclude others which also may come within the general purpose of that subsection.

A guardian, whether of an infant or other person, is a fiduciary (see section 901 (a) (6)), and, as such, is required to make and file the return for his ward and pay the tax, or the return may be made by the ward. (See articles 51-1 and 142-2.) The estate of a ward is not a taxable entity, in that respect differing from the estate of a deceased person or of a trust.

The provisions of sections 161, 162, and 163 (relating to estates and trusts, fiduciaries, and beneficiaries) contemplate that the corpus of the trust, or the income therefrom, is, within the meaning of the Act, no longer to be regarded as that of the grantor. If, by virtue of the nature and purpose of the trust, the corpus or income therefrom remains attributable to the grantor, these provisions do not apply. Thus the provisions of sections 166 and 167 deal with certain trusts which are excluded from the scope of sections 161, 162, and 163. Other trusts, not specified in sections 166 and 167, where in contemplation of law the corpus of the trust or the income therefrom is regarded as remaining in substance that of the grantor are likewise excluded from the scope of sections 161, 162, and 163. Some of such trusts are dealt with in article 166-1 and article 167-1. See section 165 as to the exemption of employees' trusts.

(*b*) *Taxability of the income.*—The fiduciary is required to make and file the return and pay the tax on the net income of the estate or trust except as otherwise provided in sections 165, 166, and 167, and articles 166-1 and 167-1. In determining whether there is any net income subject to tax and the amount thereof, consideration is to be given to the additional deductions authorized in section 162.

SEC. 162. *Net income.*—The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23 (o)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purpose and in the manner specified in section 23 (o), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit;

(b) There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficarles,[1] and the amount of the income collected by a guardian of an infant which is to be held or distributed as the court may direct, but the amount so allowed as a deduction shall be included in computing the net income of the beneficiaries whether distributed to them or not. Any amount allowed as a deduction under this paragraph shall not be allowed as a deduction under subsection (c) of this section in the same or any succeeding taxable year;

(c) In the case of income received by estates of deceased persons during the period of administration or settlement of the estate, and in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year, which is properly paid or credited during such year to any legatee, heir, or beneficiary, but the amount so allowed as a deduction shall be included in computing the net income of the legatee, heir, or beneficiary.

ART. 162-1. *Income of estates and trusts.*—In ascertaining the tax liability of the estate of a deceased person or of a trust, there is deductible from the gross income, subject to exceptions, the same deductions which are allowed to individual taxpayers. See generally section 23, and the provisions thereof governing the right of deduction for depreciation and depletion in the case of property held in trust. For items not deductible, see section 24. Against the net income of the estate or trust there are allowable certain credits, for which see sections 25 and 163.

From the gross income of the estate or trust there are also deductible (either in lieu of, or in addition to, the deductions referred to in the preceding paragraph of this article) the following:

(1) Any part of the gross income of the estate or trust for its taxable year which, by the terms of the will or of the instrument creating the trust, is paid or permanently set aside during such year for the charitable, etc., uses or purposes referred to or described in subsection (a) of section 162. This deduction is in lieu of that authorized by section 23 (o) in the case of individual taxpayers.

(2) Any income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to a beneficiary, whether or not such income is actually distributed.

(3) Any income of the estate of a deceased person for its taxable year which is properly paid or credited during such year to a legatee or heir, and any income either of such an estate or of a trust for its taxable year which is similarly paid or credited during that year to a legatee, heir, or beneficiary if there was vested in the fiduciary a discretion either to distribute or to accumulate such income.

Any income of the class described in either (2) or (3) above, which is currently distributable, or paid or credited, to a guardian for his ward is likewise deductible from the gross income of the estate or trust.

There is taxable to the estate or to the trust, unless it be taxable to the grantor of the trust (see articles 166-1 and 167-1), all income thereof accumulated for the benefit of unborn or unascertained persons or persons with contingent interests, all income either accumulated or held for future distribution pursuant to the terms of the will or trust, all income of the estate or trust for its taxable year which is not to be distributed currently to legatees or other beneficiaries (see paragraph (2) of this article), all income of the estate for its taxable year not properly paid or credited during such year to a legatee or heir, and all income either of the estate or of the trust for its taxable year which is not similarly paid or credited during that year to a legatee, heir, or beneficiary in case there was vested in the fiduciary a discretion either to distribute or to accumulate such income (see paragraph (3) of this article). In all such cases the tax is payable by the fiduciary, except the tax upon the income which is taxable to the grantor of the trust.

Any amount described in paragraph (2) or (3) above as being deductible from the gross income of the estate or trust shall be included in computing the net income of the legatees, heirs, or beneficiaries, whether distributed to them or not.

Any income of an estate or trust for its taxable year which during that year may be used, pursuant to the terms of the will or trust instrument, in the discharge or satisfaction, in whole or in part, of a legal obligation of any person is, to the extent so used, taxable to such person as though directly distributed to him as a beneficiary. (See, also, article 167-1.)

The income of an estate of a deceased person, as dealt with in the Act, is therein described as received by the estate during the period of administration or settlement thereof. The period of administration or settlement of the estate is the period required by the executor or administrator to perform the ordinary duties pertaining to administration, in particular the collection of assets and the payment of debts and legacies. It is the time actually required for this purpose, whether longer or shorter than the period specified in the local statute for the settlement of estates. If an executor, who is also named as trustee, fails to obtain his discharge as executor, the period of administration continues up to the time when the duties of administration are complete and he actually assumes his duties as trustee, whether pursuant to an order of the court or not. No taxable income is realized from the passage of property to the executor or administrator on the death of the decedent, even though it may have appreciated in value since the decedent acquired it. But see

[1] So in original.

sections 42, 43, and 44. As to the taxable gain realized, or the deductible loss sustained, upon the sale or other disposition of property by an administrator, executor, or trustee, and by a legatee, heir, or other beneficiary, see sections 111 and 112. As to capital gains and losses, see section 117. A statutory allowance paid a widow is not deductible from gross income. If real estate is sold by the devisee or heir thereof, whether before or after settlement of the estate, he is taxable individually on any profit derived.

The tax upon the net income of the estate or trust shall be paid by the fiduciary (see section 161 (b)). If the tax has been properly paid on the net income of an estate or trust, the net income on which the tax is so paid is not, in the hands of the distributee thereof (the legatee or the beneficiary), taxable as income to him.

Liability for the payment of the tax attaches to the person of the executor or administrator up to and after his discharge if prior to distribution and discharge he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed. For the extent of such liability, see section 3467 of the Revised Statutes, as amended by section 518 of the Revenue Act of 1934 (paragraph 48 of the Appendix to these regulations). Liability for the tax also follows the assets of the estate distributed to heirs, devisees, legatees, and distributees, who may be required to discharge the amount of the tax due and unpaid to the extent of the distributive shares received by them. (See section 311.) The same considerations apply to trusts.

SEC. 163. *Credits against net income.*—(a) *Credits of estate or trust.*—(1) For the purpose of the normal tax and the surtax an estate shall be allowed the same personal exemption as is allowed to a single person under section 25 (b) (1), and a trust shall be allowed (in lieu of the personal exemption under section 25 (b) (1)) a credit of $100 against net income.

(2) If no part of the income of the estate or trust is included in computing the net income of any legatee, heir, or beneficiary, then the estate or trust shall be allowed the same credits against net income for interest as are allowed by section 25 (a).

(b) *Credits of beneficiary.*—If any part of the income of an estate or trust is included in computing the net income of any legatee, heir, or beneficiary, such legatee, heir, or beneficiary shall, for the purpose of the normal tax, be allowed as credits against net income, in addition to the credits allowed to him under section 25, his proportionate share of such amounts of interest specified in section 25 (a) as are, under this Supplement, required to be included in computing his net income. Any remaining portion of such amounts specified in section 25 (a) shall, for the purpose of the normal tax, be allowed as credits to the estate or trust.

ART. 163–1. *Credits to estate, trust, or beneficiary*—(a) *Personal exemption allowed estates and trusts.*—An estate is allowed for both normal tax and surtax purposes the personal exemption of $1,000 allowed a single person under section 25 (b) (1). A trust is allowed for both normal tax and surtax purposes a credit of $100 against net income. A credit for dependents is not allowable to an estate or trust.

(b) *Credit for interest to estate or trust.*—If no part of the income of the estate or trust is included in computing the net income of any legatee, heir, or beneficiary, the estate or trust shall be allowed the credits provided in section 25 (a), in respect of interest upon certain obligations of the United States.

(c) *Credit for interest to beneficiary.*—If any part of the income of the estate or trust is included in computing the net income of any legatee, heir, or beneficiary, he is allowed for the purpose of the normal tax, in addition to his individual credits, the proportionate share of the interest upon obligations of the United States and instrumentalities of the United States which is exempt from normal tax only and is required to be included in computing net income. Any remaining portion of such interest will be allowed as a credit for the purpose of the normal tax to the estate or trust. Where the amount of the interest specified in section 25 (a) is in excess of the net income of the estate or trust, the proportionate share of such interest which each beneficiary is required to include in computing his net income and for which he is allowed a credit for normal tax purposes is an amount equal to his distributive share of the net income of the estate or trust. Each beneficiary is entitled to but one personal exemption, no matter from how many trusts he may receive income. (See section 25.)

SEC. 164. *Different taxable years.*—If the taxable year of a beneficiary is different from that of the estate or trust, the amount which he is required, under section 162 (b), to include in computing his net income, shall be based upon the income of the estate or trust for any taxable year of the estate or trust (whether beginning on, before, or after January 1, 1938) ending within or with his taxable year.

SEC. 165. *Employees' trusts.*—(a) *Exemption from tax.*—A trust forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of some or all of his employees—

(1) if contributions are made to the trust by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, and

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees,

shall not be taxable under section 161, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. Such distributees shall for the purpose of the normal tax be allowed as credits against net income such part of the amount so distributed or made available as represents the items of interest specified in section 25 (a).

(b) *Taxable year beginning before January 1, 1939.*—The provisions of clause (2) of subsection (a) shall not apply to a taxable year beginning before January 1, 1939.

ART. 165–1. *Employees' trusts* — (a) *Plans and trusts for employees.*—A "stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of some or all of his employees" is a definite written program and arrangement signed by such employer and communicated to such employees, solely designed and applied to enable all or a large percentage of the total number of the employer's clerks and workmen (as distinguished from persons in positions of authority) to share in the capital or profits of such employer's trade or business or to provide for the livelihood of such employees upon their retirement from employment. A "trust forming part of a stock bonus, pension, or profit-sharing plan" is a trust formed and availed of solely to aid in the proper execution of one of the plans defined in the preceding sentence. This phrase does not include devices for paying profits or salaries to shareholders or officers, but a trust, applied without discrimination to all the employees and officers of an employer as one group, may be within its meaning.

(b) *Taxable years beginning prior to January 1, 1939.*—A trust forming part of a plan defined in paragraph (a) is exempt for taxable years beginning prior to January 1, 1939, if: (1) contributions are made to the trust by such employer, such employees or both; and (2) such contributions are made for the purpose of distributing to such employees both the earnings and principal of the fund accumulated by the trust; and (3) the fund is accumulated by the trust in accordance with the plan of which the trust is a part.

(c) *Taxable years beginning after December 31, 1938.*—A trust forming part of a plan defined in paragraph (a) is exempt for taxable years beginning after December 31, 1938, if all three tests designated in paragraph (b) as (1), (2), and (3) are met; and if also (4) the trust instrument makes it impossible (in the taxable year and at any time thereafter prior to the satisfaction of all liabilities to employees covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of such employees.

(d) *Impossibility of diversion.*—As used in section 165 (a) (2), the phrase "if under the trust instrument it is impossible" means that the trust instrument must definitely and affirmatively make it impossible for the non-exempt diversion or use to occur, whether by operation or natural termination of the trust, by power of revocation or amendment, by the happening of a contingency, by collateral arrangement, or by any other means. It is not essential that the employer relinquish all power to modify or terminate the rights of certain employees covered by the trust, but except as stated in paragraph (e), it must be impossible for trust funds to be used or diverted for purposes other than for the exclusive benefit of his employees. The diversion of substantial amounts of trust funds from one group of employees to another group of employees is not for the "exclusive" benefit of employees even though both groups were covered by the trust, if the employer (or other non-employee) receives substantial indirect benefit thereby, as, for example, through securing greater loyalty from the favored group, or through the shifting of expected pension benefits to a younger group and the postponement of part of the employer's contributions to a later date. As used in section 165 (a) (2), the phrase "purposes other than for the exclusive benefit of his employees" includes all objects or aims not solely designed for the proper satisfaction of all liabilities to employees covered by the trust.

(e) *Meaning of "liabilities."*—The report of the Senate Committee on Finance states that the intent and purpose in section 165 (a) (2) of the phrase "prior to the satisfaction of all liabilities with respect to employees under the trust" is to permit the employer to reserve the right to recover only such balance in the trust at its termination as is "due to erroneous actuarial computations during the previous life of the trust." An "erroneous actuarial computation" means a mistake of an actuarial character reasonably made by a careful person skilled in calculating the amount necessary to satisfy pecuniary obligations depending on the average length of life of a group of individuals, and of such a type that the employer may reserve the right to recover an amount remaining in the trust because of the mistake without conflicting with the purpose for which section 165 (a) (2) was enacted. For example, if a trust created to supply pensions of $25 a month for 10,000 employees for the remainder of their lives after age 60 has been used to supply such pensions only to 500 employees, an amount remaining in the trust for this reason is not due to such a mistake, but to a change in plan; while if $25 a month after age 60 is paid to the 10,000 employees during their lives, but their average duration of life proves less than might reasonably have been expected, an amount remaining in the trust for this reason is due to an "erroneous actuarial computation." Employers might recover more than amounts resulting from such errors if the term "liabilities" included only such obligations to employees as are legally fixed and certain. Hence, the term was used in the Act in its broad common meaning to include both fixed and contingent obligations to employees. For example, if 1,000 employees are covered by a trust forming part of a pension plan, 300 of whom have satisfied all the requirements for a monthly pension, while the remaining 700 employees have not yet completed the required period of service, contingent obligations to such 700 employees have nevertheless arisen which constitute "liabilities" within the meaning of that term. It must be impossible for the employer (or other non-employee) to recover other than such amounts as remain in the trust because of "erroneous actuarial computations" after the satisfaction of all such fixed and contingent obligations, and the trust instrument must contain a definite affirmative provision to that effect whether the obligations to employees have their source in the trust instrument itself, in the plan of which the trust forms a part, or in some collateral instrument or arrangement forming a part of such plan, and whether such obligations are, technically speaking, liabilities of the employer, of the trust, or of some other person forming a part of the plan or connected with it.

(f) *Portions of years; affiliated corporations.*—Exempt status must be maintained throughout the entire taxable year of the trust in order to obtain any exemption for such year. A trust forming part of a plan of affiliated corporations for their employees may be exempt if all requirements are otherwise satisfied.

(g) *Proof of exemption.*—Every trust claiming exemption must prove its right thereto by filing with the collector: (1) an affidavit showing its character, purpose, activities, sources and disposition of corpus and income, and every fact which might affect its status for exemption, (2) verified copies of the trust instrument and of the employer's plan, showing all amendments, and (3) the latest financial statement, showing the assets, liabilities, receipts, and disbursements of the trust. The financial statement must be filed each year, but the documents mentioned in (1) and (2) need not be filed after the first year except when necessary to show changes occurring since the last filing.

SEC. 166. *Revocable trusts.*—Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—

(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or

(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom,

then the income of such part of the trust shall be included in computing the net income of the grantor.

ART. 166-1. *Trusts with respect to the corpus of which the grantor is regarded as remaining in substance the owner.*—(a) *Scope.*—If the grantor of a trust is regarded, within the meaning of the Act, as remaining in substance the owner of the corpus thereof, the income therefrom is not taxable in accordance with the provisions of sections 161, 162, and 163 but remains attributable and taxable to the grantor. This article deals with the taxation of such income. As used in this article, the term "corpus" means any part or the whole of the property, real or personal, constituting the subject matter of the trust.

(b) *Test of taxability to grantor.*—Section 166 defines with particularity instances in which the grantor is regarded as in substance the owner of the corpus by reason of the fact that he has retained power to revest the corpus in himself. For the purposes of this article the grantor is deemed to have retained such power if he, or any person not having a substantial interest in the corpus or the income therefrom adverse to the grantor, or both, may cause the title to the corpus to revest in the grantor. A bare legal interest, such as that of a trustee, is never substantial and never adverse. If the title to the corpus will revest in the grantor upon the exercise of such power, the income of the trust is attributed and taxable to the grantor regardless of—

(1) whether such power or ability to retake the trust corpus to the grantor's own use is effected by means of a power to revoke, to terminate, to alter or amend, or to appoint;

(2) whether the exercise of such power is conditioned on the precedent giving of notice, or on the elapsing of a period of years, or on the happening of a specified event;

(3) the time at which the title to the corpus will revest in the grantor in possession and enjoyment, whether such time is within the taxable year or not, or whether such time be fixed, determinable, or certain to come;

(4) whether the power to revest in the grantor title to the corpus is in the grantor, or in any person not having a substantial interest in the corpus or income therefrom adverse to the grantor, or in both;

(5) when the trust was created.

But the provisions of section 166 are not to be regarded as excluding from taxation to the grantor the income of other trusts, not specified therein, in which the grantor is, for the purposes of the Act, similarly regarded as remaining in substance the owner of the corpus. The grantor is regarded as in substance the owner of the corpus, if, in view of the essential nature and purpose of the trust, it is apparent that the grantor has failed to part permanently and definitively with the substantial incidents of ownership in the corpus.

In determining whether the grantor is in substance the owner of the corpus, the Act has its own standard, which is a substantial one, dependent neither on the niceties of the particular conveyancing device used nor on the technical description which the law of property gives to the estate or interest transferred to the trustees or beneficiaries of the trust. In that determination, among the material factors are: The fact that the corpus is to be returned to the grantor after a specific term; the fact that the corpus is or may be administered in the interest of the grantor; the fact that the anticipated income is being appropriated in advance for the customary expenditures of the grantor or those which he would ordinarily and naturally make; and any other circumstance bearing on the impermanence and indefiniteness with which the grantor has parted with the substantial incidents of ownership in the corpus.

Thus the grantor is regarded as being in substance the owner of the corpus if, in any case, the trust amounts to no more than an arrangement whereby the grantor, in the ordering of his affairs, finds it expedient to entrust for a period the title to, and custody or management of, certain of his property to a trustee, the income from such property to be used by the trustee during such period to make those expenditures which the grantor would customarily or ordinarily or naturally make and to which the grantor chooses to commit himself in advance, while the corpus is to be held intact, for return in due course to the grantor. In such a case, it is immaterial that, at the time of the creation of the trust an irrevocable disposition or consummated gift was made of those property rights which consist of the right to the expected future income of the corpus for the specified period. On the other hand, if the grantor, incident to a definitive and permanent disposition of certain of his property, creates the trust in order to conserve the property, not for himself but for the donees, who will ultimately enjoy it, the provisions of sections 161, 162, and 163 are applicable.

For example, a grantor is regarded as remaining in substance the owner of the corpus of the trust, if he has placed it in trust for his son, John,

(A) for the term of three years, at the end of which time the trust might be extended for a like period at the option of the grantor and successively thereafter, but in the absence of such an extension the title is once more to revest in the grantor in possession and enjoyment; or

(B) for the term of a year and a day, then to be distributed to whomsoever the wife of the grantor shall by deed appoint (the wife not having a substantial adverse interest in the disposition of the corpus or the income therefrom); or

(C) for the term of the grantor's life, then to be distributed to John, the grantor reserving, however, the right to alter, amend, or revoke any provision of the trust instrument, upon notice of a year and a day.

In these typical cases the grantor is regarded as having retained the substantial incidents of ownership with respect to the income-producing property since the corpus will or may once more revest in himself in (A) upon the expiration of the trust period if the grantor does not exercise his option to extend the trust, in (B) upon the designation of the grantor as distributee, by a person not substantially and adversely interested, and in (C) upon the revocation of the trust instrument or an alteration or amendment thereof, resulting in the designation of the grantor as distributee.

If, however, the grantor strips himself of the substantial incidents or attributes of ownership in the corpus retained by him so that he ceases to be regarded as in substance the owner of the corpus, the income thereof realized after the effective date of such divesting is not taxable to the grantor but is taxable as provided in sections 161, 162, and 163.

A person may have an interest that is both substantial and adverse to the grantor in the disposition of only part of the corpus or the income therefrom. If the power to revest title in the grantor is vested in him in conjunction with such person, or is vested solely in such person, there is to be excluded in computing the net income of the grantor only the income of such part.

(c) *Income and deductions.*—If the grantor is regarded as remaining in substance the owner of the corpus the gross income of such corpus shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to the corpus as he would have been entitled to had the trust not been created.

SEC. 167. *Income for benefit of grantor.*—(a) *Where any part of the income of a trust*—

(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23 (o), relating to the so-called "charitable contribution" deduction);

then such part of the income of the trust shall be included in computing the net income of the grantor.

(b) As used in this section, the term "in the discretion of the grantor" means "in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question".

ART. 167-1. *Trusts in the income of which the grantor retains an interest*—(a) *Scope.*—Section 167 prescribes that the income, or any part of the income, of certain trusts shall be taxed to the grantor, not because the grantor has retained a certain interest in the *corpus* of the trust (as in section 166), but because of his retention of a certain interest in the *income* of the trust. This article deals with the taxation of such income. The term "income," as used in this article, means any part or the whole of the income of the trust.

(b) *Test of taxability to the grantor.*—The test prescribed by the Act as to the sufficiency of the grantor's retained interest in the trust income, resulting in the taxation of such income to the grantor, is whether he has failed to divest himself, permanently and definitively, of every right which might, by any possibility, enable him to have such income, at some time, distributed to him, either actually or constructively. Such a distribution to the grantor occurs within the meaning of section 167 if the income is paid to him or to another in obedience to his direction or if the income is applied in payment of premiums upon policies of insurance on the grantor's life.

For the purposes of this article, the sufficiency of the grantor's retained interest in the income is not affected by the fact that the grantor has provided that the right to so effect or direct the distribution of income is, or may at some future time be, vested in any person (either alone or in conjunction with the grantor) not having a substantial interest in the income adverse to the grantor. A bare legal interest, such as that of a trustee, is never substantial and never adverse.

If the grantor has retained any such interest in the income, such income is taxable to the grantor regardless of—

(1) whether it may be distributed currently or accumulated for future distribution;

(2) whether such distribution, either current or subject to accumulation, is fixed by the trust instrument or is dependent on an exercise of discretion;

(3) whether, if such distribution is in any way effected by or dependent on an exercise of discretion, the person exercising the discretion is the grantor or a person not having a substantial interest in the income adverse to the grantor, or both;

(4) the time or times of such distribution, whether within or without the taxable period, whether conditioned on the precedent giving of notice, or on the elapsing of an interval of time, or on the happening of a specified event, or otherwise;

(5) when the trust was created.

Thus the inclusion of any trust within the scope of section 167 is based on the fact that the grantor has retained an interest in the income therefrom by which he is, or may be enabled at some time, to receive its benefits. But the provisions of section 167 are not to be regarded as excluding from taxation to the grantor the income of other trusts, not specified therein, in which the grantor is, for the purposes of the Act, similarly regarded as remaining in substance the owner of the trust income. If, for example, trust income is applied in satisfaction of the grantor's legal obligation whether to pay a debt, to support dependents, to pay alimony, to furnish maintenance and support, or otherwise, such income is in all cases taxable to the grantor.

If the grantor strips himself permanently and definitely of every such interest retained by him, the income of the trust realized after such divesting takes effect is not taxable to the grantor but is taxable as provided in sections 161 and 162.

A person may have an interest that is both substantial and adverse to the grantor in the disposition of only part of the income. There is to be excluded in computing the net income of the grantor only that part of the trust income in the disposition of which such person has a substantial interest adverse to the grantor.

(c) *Income and deductions.*—If, as to any of the income, the test of taxability to the grantor is satisfied, such income shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to such income as he would have been entitled to had such income been distributable currently to him.

SEC. 168. *Taxes of foreign countries and possessions of United States.*—The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as credit against the tax of the beneficiary of an estate or trust to the extent provided in section 131.

SEC. 169. *Common trust funds.*—(a) *Definitions.*—The term "common trust fund" means a fund maintained by a bank (as defined in section 104)—

(1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian; and

(2) in conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System pertaining to the collective investment of trust funds by national banks.

(b) *Taxation of common trust funds.*—A common trust fund shall not be subject to taxation under this title, Title IA, or section 105 or 106 of the Revenue Act of 1935, or section 601 or 602 of this Act, and for the purposes of such titles and sections shall not be considered a corporation.

(c) *Income of participants in fund*—(1) *Inclusions in net income.*—Each participant in the common trust fund in computing its net income shall include, whether or not distributed and whether or not distributable—

(A) As a part of its short-tern capital gains or losses, its proportionate share of the net short-term capital gain or loss of the common trust fund;

(B) As a part of its long-term capital gains or losses, its proportionate share of the net long-term capital gain or loss of the common trust fund;

(C) Its proportionate share of the ordinary net income or the ordinary net loss of the common trust fund, computed as provided in subsection (d).

(2) *Credit for partially exempt interest.*—The proportionate share of each participant in the amount of interest specified in section 25 (a) received by the common trust fund shall for the purposes of this Supplement be considered as having been received by such participant as such interest.

(d) *Computation of common trust fund income.*—The net income of the common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(1) There shall be segregated the short-term capital gains and losses and the long-term capital gains and losses, and the net short-term capital gain or loss and the net long-term capital gain or loss shall be computed;

(2) After excluding all items of either short-term or long-term capital gain or loss, there shall be computed—

(A) An ordinary net income which shall consist of the excess of the gross income over the deductions; or

(B) An ordinary net loss which shall consist of the excess of the deductions over the gross income;

(3) The so-called "charitable contribution" deduction allowed by section 23 (o) shall not be allowed.

(e) *Admission and withdrawal.*—No gain or loss shall be realized by the common trust fund by the admission or withdrawal of a participant. The withdrawal of any participating interest by a participant shall be treated as a sale or exchange of such interest by the participant.

(f) *Returns by bank.*—Every bank (as defined in section 104) maintaining a common trust fund shall make a return under oath for each taxable year, stating specifically, with respect to such fund, the items of gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the participants who would be entitled to share in the net income if distributed and the amount of the proportionate share of each participant. The return shall be sworn to as in the case of a return filed by the bank under section 52.

(g) *Different taxable years of common trust fund and participant.*—(1) *General rule.*—If the taxable year of the common trust fund is different from that of a participant, the inclusions with respect to the net income of the common trust fund, in computing the net income of the participant for its taxable year shall be based upon the net income of the common trust fund for any taxable year of the common trust fund (whether beginning on, before, or after January 1, 1938) ending within or with the taxable year of the participant.

(2) *Exception.*—If the taxable year of the common trust fund begins before January 1, 1938, and the taxable year of a participant begins after December 31, 1937, the computation of the net income of the common trust fund, and the inclusions with respect to the common trust fund net income, in computing the net income of such participant, shall be made by the method provided in section 169 of the Revenue Act of 1936, and not by the method provided in subsections (c) and (d) of this section.

ART. 169-1. *Common trust fund defined.*—Under section 169 two conditions must be satisfied by a fund maintained by a bank (as defined in section 104) before such fund may be designated as a "common trust fund." These conditions are that such fund must be maintained by such a bank—

(a) Exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank, whether acting alone or in conjunction with one or more co-fiduciaries, but solely in its capacity: (1) as a trustee of a trust created by will, deed, agreement, declaration of trust, or order of court, (2) as an executor of the will of, or as an administrator of the estate of, a deceased person, or (3) as a guardian (by whatever name known under local law) of the estate of an infant, of an incompetent individual or of an absent individual and

(b) In conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System pertaining to the collective investment of trust funds by national banks, whether or not the bank maintaining such fund is a national bank or a member of the Federal Reserve System.

Except as otherwise provided in this article and articles 169-2 to 169-5, inclusive, the term "participant" refers to any trust or estate, the moneys of which have been contributed to the common trust fund.

ART. 169-2. *Income of participants in common trust fund.*—(a) If the taxable year of a common trust fund begins on or after January 1, 1938, each participant is required to include in computing its net income for its taxable year within which or with which the taxable year of the fund ends, whether or not distributed and whether or not distributable:

(1) Its proportionate share of the net short-term capital gain or loss of the common trust fund, computed as provided in article 169-3, as a part of its short-term capital gains or losses;

(2) Its proportionate share of the net long-term capital gain or loss of the common trust fund, computed as provided in article 169-3, as a part of its long-term capital gains or losses;

(3) Its proportionate share of the ordinary net income or the ordinary net loss of the common trust fund, computed as provided in article 169-3.

(b) Each participant's proportionate share in the amount of interest specified in section 25 (a) received by the common trust fund shall be deemed to have been received by such participant as such interest. For the purposes of the Act, any tax withheld at the source from income of the fund shall be deemed to have been withheld proportionately from the participants to whom such income is allocated.

(c) The proportionate share of each participant in the net short-term capital gain or loss, the net long-term capital gain or loss, the ordinary net income or ordinary net loss, the partially exempt interest, and the tax withheld at the source shall be determined in accordance with the method of accounting adopted by the bank in accordance with the written plan under which the common trust fund is established and administered, provided such method clearly reflects the income of each participant.

The items of income and deductions are, therefore, to be allocated to the periods between valuation dates within the taxable year established by such plan in which they were realized or sustained, and the ordinary net income or ordinary net loss, the net short-term capital gain or loss, and the net long-term capital gain or loss computed for each such period. The proportionate shares of the participants in such items are then to be determined. The provisions of this paragraph may be illustrated by the following example:

Example: The plan of a common trust fund provides for quarterly valuation dates and for the computation and the distribution of the income upon a quarterly basis, except that there shall be no distribution of capital gains. The participants are as follows: Trusts A, B, C, and D for the first quarter; Trusts A, B, C, and E for the second quarter; and Trusts A, B, F, and G for the third and fourth quarters, the participants having equal participating interests. As computed upon the quarterly basis, the ordinary net income and the short-term capital gain for the taxable year were as follows:

	First quarter	Second quarter	Third quarter	Fourth quarter	Total
Ordinary net income	$200	$300	$200	$400	$1,100
Net short-term capital gain (or loss)	200	[1] 100	200	[1] 100	200

[1] Loss.

The participants' shares of ordinary net income are as follows:

Participants' Shares of Ordinary Net Income

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$75	$50	$100	$275
B	50	75	50	100	275
C	50	75			125
D	50				50
E		75			75
F			50	100	150
G			50	100	150
Total	200	300	200	400	1,100

The participants' shares of net short-term capital gain or loss are as follows:

Participants' Shares of Net Short-Term Capital Gain (or Loss).

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	[1] $25	$50	[1] $25	$50
B	50	[1] 25	50	[1] 25	50
C	50	[1] 25			25
D	50				50
E		[1] 25			[1] 25
F			50	[1] 25	25
G			50	[1] 25	25
Total	200	[1] 100	200	[1] 100	200

[1] Loss.

If in the above example the common trust fund also had long-term capital gains or losses, the treatment of such gains or losses would be similar to that accorded to the short-term capital gains and losses.

(*d*) The provisions of sections 161, 162, 166, and 167 are applicable in determining the extent to which each participant's proportionate share of the income of the common trust fund is taxable to the participant, or to the beneficiaries or the grantor of the participant.

(*e*) If the taxable year of the common trust fund begins before January 1, 1938, each participant is required to include in its gross income for its taxable year (even though beginning after December 31, 1937) within which or with which the taxable year of the fund ends, its proportionate share of the net income (computed in accordance with the provisions of section 169 of the Revenue Act of 1936).

ART. 169-3. *Computation of common trust fund income.*—The net income of the common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that:

(1) No deduction shall be allowed under section 23 (o) for charitable contributions.

(2) The short-term capital gains and losses of the common trust fund and its long-term capital gains and losses are required to be segregated and the computation made of the net short-term capital gain or loss and the net long-term gain or loss, as the case may be. A common trust fund is not allowed the benefit of the net short-term capital loss carry-over provided by section 117 (e).

(3) The ordinary net income, that is, the excess of the gross income over the deductions, or the ordinary net loss, that is, the excess of the deductions over the gross income, shall be computed after excluding all items of either short-term or long-term capital gain or loss.

ART. 169-4. *Admission and withdrawal of participants from the common trust fund—(a) Gain or loss.*—The common trust fund realizes no gain or loss by the admission or withdrawal of a participant, and the basis of the assets and the period for which they are deemed to have been held by the common trust fund for the purposes of section 117 (b) are unaffected by such an admission or withdrawal. If a participant withdraws the whole or any part of its participating interest from the common trust fund, such withdrawal shall be treated as a sale or exchange by the participant of the participating interest or portion thereof which is so withdrawn. A participant is not deemed to have withdrawn any part of its participating interest in the common trust fund so as to have completed a closed transaction by reason of the segregation and administration of an investment of the fund, pursuant to the provisions of subdivision (c) (7) of section 17 of Regulation F of the Board of Governors of the Federal Reserve System, effective December 31, 1937, for the benefit of all the then participants in the common trust fund. (See paragraphs 27-30 of the Appendix to these regulations.) Such segregated investments shall be considered as held by, or on behalf of, the common trust fund for the benefit ratably of all participants in the common trust fund at the time of segregation, and any income or loss arising from its administration and liquidation shall constitute income or loss to the common trust fund apportionable among the participants for whose benefit the investment was segregated.

(*b*) *Basis for gain or loss upon withdrawal.*—The participant's gain or loss upon withdrawal of its participating interest or portion thereof shall be measured by the difference between the amount received upon such withdrawal and the basis of the participating interest or portion thereof withdrawn (with proper adjustments as provided in section 113 (b) to the date of withdrawal) plus the additions prescribed in paragraph (c) of this article and minus the reductions prescribed in paragraph (*d*) of this article. The amount received by the participant shall be the sum of any money plus the fair market value of property (other than money) received upon such withdrawal. The basis of the participating interest or portion thereof withdrawn shall be the money contributed by the participant to the common trust fund to acquire the participating interest or portion thereof withdrawn. Such basis shall not be reduced on account of the segregation of any investment in the common trust fund pursuant to the provisions of subdivision (c) (7) of section 17 of Regulation F of the Board of Governors of the Federal Reserve System, effective December 31, 1937. For the purpose of making the adjustments, additions, and reductions with respect to basis as prescribed in this paragraph, the ward, rather than the guardian, shall be deemed to be the participant; and the grantor, rather than the trust to the extent that the income of the trust is taxable to the grantor pursuant to the provisions of section 166 or 167, shall be deemed to be the participant.

(*c*) *Additions to basis.*—As prescribed in paragraph (*b*) of this article, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, there shall be added to the basis of the participating interest or portion thereof withdrawn an amount equal to the aggregate of the following items, to the extent that they were properly allocated to the participant for a taxable year of the common trust fund, and were not distributed to the participant prior to withdrawal:

(1) wholly exempt income of the common trust fund for any taxable year,

(2) net income of the common trust fund for the taxable years beginning

after December 31, 1935 and prior to January 1, 1938,

(3) net short-term capital gain of the common trust fund for each taxable year beginning on or after January 1, 1938,

(4) the excess of the gains over the losses recognized to the common trust fund for each taxable year beginning on or after January 1, 1938, upon sales or exchanges of capital assets held for more than 18 months, and

(5) ordinary net income of the common trust fund for each taxable year beginning on or after January 1, 1938.

(*d*) *Reductions in basis.*—As prescribed in paragraph (*b*) of this article, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, the basis of the participating interest or portion thereof withdrawn shall be reduced by such portions of the following items as were allocable to the participant with respect to the participating interest or portion thereof withdrawn:

(1) the amount of the excess of the allowable deductions of the common trust fund over its gross income for the taxable years beginning after December 31, 1935, and prior to January 1, 1938, and

(2) the amount of the net short-term capital loss, net long-term capital loss and ordinary net loss of the common trust fund for each taxable year beginning on or after January 1, 1938.

ART. 169–5. *Returns of common trust funds.*—A bank maintaining a common trust fund shall make a return of income of the common trust fund, regardless of the amount of its net income. If a bank maintains more than one common trust fund, a separate return shall be made for each. The return shall be made for the taxable year of the common trust fund on the form prescribed by the Commissioner, in accordance with these regulations and the instructions on the form or issued therewith. The return of a common trust fund shall state specifically with respect to the fund the items of gross income and the deductions allowed under Title I, and shall include each participant's name and address and its proportionate share of the net short-term capital gain or loss, the net long-term capital gain or loss, and the ordinary net income or loss. See article 169–2. A copy of the plan of the common trust fund must be filed with the return. If, however, a copy of such plan has once been filed with a return, it need not again be filed if the return contains a statement showing when and where it was filed. If the plan is amended in any way after such copy has been filed, a copy of the amendment must be filed with the return for the taxable year in which the amendment was made. Each such return shall be sworn to in the same manner as the return filed by the bank under section 52.

CHAPTER XXIV

Partnerships

Supplement F—Partnerships

SEC. 181. *Partnership not taxable.*—Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

ART. 181–1. *Partnerships.*—Partnerships as such are not subject to taxation under the Act, but are required to make returns of income. (See sections 187 and 188.) For definition of what the term "partnership" includes, see section 901 (a) (3).

SEC. 182. *Tax of partners.*

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

(a) As a part of his short-term capital gains or losses, his distributive share of the net short-term capital gain or loss of the partnership.

(b) As a part of his long-term capital gains or losses, his distributive share of the net long-term capital gain or loss of the partnership.

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

ART. 182–1. *Distributive share of partners.*—(*a*) If the taxable year of the partnership begins on or after January 1, 1938, each partner is required to include in his return for his taxable year within which or with which the taxable year of the partnership ends, whether or not distributed:

(1) As a part of his short-term capital gains or losses, his distributive share of the net short-term capital gain or loss of the partnership.

(2) As a part of his long-term capital gains or losses, his distributive share of the net long-term capital gain or loss of the partnership.

(3) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

(*b*) If the taxable year of the partnership begins before January 1, 1938, each partner is required to include in his return for his taxable year (even though beginning after December 31, 1937) within which or with which the taxable year of the partnership ends, his distributive share, whether or not distributed, of the net income of the partnership as determined by the method provided in sections 182 and 183 of the Revenue Act of 1936. See section 188 of the Revenue Act of 1938.

(*c*) If separate returns are made by the husband and wife domiciled in a community property State, and the husband only is a member of a partnership, the part of his distributive share of the partnership's net short-term capital gain or loss, net long-term capital gain or loss, or ordinary net income or ordinary net loss, which is, or is derived from, community property, should be reported by the husband and by the wife in equal proportions. In the case of a partnership closely related to other trades or businesses, see section 45.

SEC. 183. *Computation of partnership income.*—(*a*) *General rule.*—The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual, except as provided in subsections (*b*) and (*c*).

(*b*) *Segregation of items.*—(1) Capital gains and losses.—There shall be segregated the short-term capital gains and losses and the long-term capital gains and losses, and the net short-term capital gain or loss and the net long-term capital gain or loss shall be computed.

(2) Ordinary net income or loss.—After excluding all items of either short-term or long-term capital gain or loss, there shall be computed—

(A) An ordinary net income which shall consist of the excess of the gross income over the deductions; or

(B) An ordinary net loss which shall consist of the excess of the deductions over the gross income.

(c) *Charitable contributions.*—In computing the net income of the partnership the so-called "charitable contribution" deduction allowed by section 23 (o) shall not be allowed; but each partner shall be considered as having made payment, within his taxable year, of his distributive portion of any contribution or gift, payment of which was made by the partnership within its taxable year, of the character which would be allowed to the partnership as a deduction under such section if this subsection had not been enacted.

ART. 183–1. *Computation of partnership income.*—The net income of the partnership shall be computed in the same manner and on the same basis as the net income of an individual, except that:

(1) The partnership is required to segregate its short-term capital gains and losses and its long-term capital gains and losses and to compute the net short-term capital gain or loss and the net long-term capital gain or loss, as the case may be. A partnership is not allowed the benefit of the net short-term capital loss carry-over provided by section 117 (e).

(2) The partnership is further required, after excluding all items of either short-term or long-term capital gain or loss, to compute (*a*) an ordinary net income which consists of the excess of the gross income over the deductions, or (*b*) an ordinary net loss which consists of the excess of the deductions over the gross income. In the computation of its ordinary net income or ordinary net loss, the partnership is denied the so-called charitable contribution deduction allowed by section 23 (o), but each partner is considered as having made payment, within his taxable year, of his distributive portion of any contribution or gift, payment of which was made by the partnership within its taxable year, of a character which would be allowed to the partnership as a deduction if section 183 (c) had not been enacted. Payments made to a partner for services rendered and for interest on capital contributions are not deductible in computing the net income of the partnership, such payments being held to represent a division of partnership profits.

SEC. 184. *Credits against net income.*—The partner shall, for the purpose of the normal tax, be allowed as a credit against his net income, in addition to the credits allowed to him under section 25, his proportionate share of such amounts (not in excess of the net income of the partnership) of interest specified in section 25 (a) as are received by the partnership.

ART. 184–1. *Credits allowed partners.*—The credits against net income provided in section 25 are not applicable to partnerships as such. An individual partner, however, is entitled for the purpose of the normal tax to a credit against his net income, in addition to the credits allowed to him under section 25, of his proportionate share of such amounts (not in excess of the net income of the partnership) of interest specified in section 25 (a) as are received by the partnership. There shall be included in the return of the partnership a statement of the amounts of such interest and the proportionate share thereof of each partner.

SEC. 185. *Earned income.*—In the case of the members of a partnership the proper part of each share of the net income which consists of earned income shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary and shall be separately shown in the return of the partnership.

ART. 185–1. *Earned income credit of partners.*—For the purpose of computing the earned income credit against net income (see section 25 (a) (3) and (4)), a member of a partnership is entitled to treat a proper part of his distributive share of the partnership net income as earned income. Such part cannot exceed a reasonable allowance as compensation for personal services actually rendered by the partner in connection with the partnership business. In the case of a partnership which is engaged in a trade or business in which capital is a material income-producing factor and in the trade or business of which the partner renders personal services which are material to the earning of the partnership income, the earned income of the partner from the partnership is a reasonable allowance as compensation for the personal services actually rendered by him, but not in excess of 20 percent of his share of the net profits of the partnership (computed without deduction for so-called salaries to members). In such a case, if reasonable compensation is less than 20 percent of the partner's share of the net profits, the earned income is the full amount of the reasonable compensation, but, if reasonable compensation is more than 20 percent of the partner's share of the net profits, then the earned income is 20 percent of the partner's share of such profits.

There must be included in the return of the partnership a statement showing the names of the members and the amount (determined in accordance with the first paragraph of this article) of each partner's distributive share of the partnership net income which consists of earned income.

Example: A partnership composed of A, B, and C is engaged in the retail men's clothing business. Each partner is entitled to one-third of the net profits, after deduction of so-called salaries to members. A devotes most of his time to the business and is paid a salary of $10,000. B devotes half of his time to the business and is paid a salary of $5,000. C devotes none of his time to the business and receives no salary. The net profits of the partnership for the taxable year, computed without deduction for so-called salaries to members, are $24,000. The earned income of the partners from the partnership is as follows: Although A received a salary of $10,000 and B a salary of $5,000, since the partnership is engaged in a business in which capital is a material income-producing factor, the earned income of each from the partnership is limited to 20 percent of his share of the net profits. A's share of the net profits is $13,000 ($10,000 (salary)+$3,000 (⅓ of net profits after deduction of $15,000 for salaries)). Twenty percent of $13,000 is $2,600, to which amount A's earned income from the partnership is limited. Since B's share of the net profits is $8,000 ($5,000+$3,000), 20 percent thereof, or $1,600, is B's earned income from the partnership. C has no earned income from the partnership, since he renders no personal services in connection with the partnership business.

SEC. 186. *Taxes of foreign countries and possessions of United States.*—The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of the member of a partnership to the extent provided in section 131.

SEC. 187. *Partnership returns.*—Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title and such other information for the purpose of carrying out the provisions of this title as the Commissioner with the approval of the Secretary may by regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

ART. 187–1. *Partnership returns.*—Every partnership shall make a return of income, regardless of the amount of its net income (see section 901 (a) (3) defining the term "partnership"). The return shall be on Form 1065; shall state specifically the information required to be stated by the return form; shall be filled in according to the instructions contained thereon or issued with respect thereto; and shall be sworn to by one of the partners. Such return shall be made for the taxable year of the partnership, that is, for its annual accounting period (fiscal year or calendar year, as the case may be), irrespective of the taxable years of the partners. (See sections 182 and 183.) If the partnership makes any change in its accounting period, it shall make its return in accordance with the provisions of section 47.

SEC. 188. *Different taxable years of partner and partnership*—(a) *General rule.*—If the taxable year of a partner is different from that of the partnership, the inclusions with respect to the net income of the partnership, in computing the net income of the partner for his taxable year, shall be based upon the net income of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1938) ending within or with the taxable year of the partner.

(b) *Partnership year beginning in 1937.*—If the taxable year of the partnership begins before January 1, 1938, and the taxable year of a partner begins after December 31, 1937, the computation of the net income of the partnership, and the inclusions with respect to the partnership net income, in computing the net income of such partner, shall be made by the method provided in sections 182 and 183 of the Revenue Act of 1936 and not by the method provided in sections 182 and 183 of this Act.

CHAPTER XXV

Insurance Companies

Supplement G—Insurance Companies

SEC. 201. *Tax on life insurance companies*—(a) *Definition.*—When used in this title the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

ART. 201 (a)–1. *Life insurance companies: Definition.*—The term "life insurance company" as used in Title I is defined in section 201 (a). In determining whether an insurance company is a "life insurance company" as defined in section 201 (a), no reserve shall be regarded as held for the fulfillment of an insurance contract unless it conforms to the definition of "reserve" contained in article 203 (a) (2)–1.

[SEC. 201. *Tax on life insurance companies.*]

(b) *Imposition of tax.*—(1) *In general.*—In lieu of the tax imposed by sections 13 and 14, there shall be levied, collected, and paid for each taxable year upon the special class net income of every life insurance company a tax of 16½ per centum of the amount thereof.

(2) *Special class net income of foreign life insurance companies.*—In the case of a foreign life insurance company, the special class net income shall be an amount which bears the same ratio to the special class net income, computed without regard to this paragraph, as the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States bear to the reserve funds held by it at the end of the taxable year upon all business transacted.

(3) *No United States insurance business.*—Foreign life insurance companies not carrying on an insurance business within the United States and holding no reserve funds upon business transacted within the United States, shall not be taxable under this section but shall be taxable as other foreign corporations.

ART. 201 (b)–1. *Life insurance companies: Rate of tax.*—Life insurance companies are subject to the tax imposed by section 201 (b), in lieu of the tax imposed by sections 13 and 14. The rate is 16½ percent, and the tax is imposed upon the special class net income as defined in section 14. The net income of life insurance companies differs from the net income of other corporations. Life insurance companies are entitled to the credits provided in section 26 (a) and (b) and are not subject to the provisions of section 117 (capital gains and losses).

All provisions of the Act and of these regulations not inconsistent with the specific provisions of sections 201–203 are applicable to the assessment and collection of the tax imposed by section 201 (b), and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120L.

ART. 201 (b)–2. *Foreign life insurance companies: Net income.*—The special class net income of a foreign life insurance company carrying on an insurance business within the United States or holding reserve funds upon business transacted within the United States consists of that proportion of its net income from all sources, within and without the United States, computed under the provisions of sections 202 and 203 minus the credits provided in section 26 (a) and (b), which the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States bear to the reserve funds held by it at the end of the taxable year upon all business transacted. Other foreign life insurance companies are not taxable under section 201 (b), but are taxable the same as other foreign corporations. See section 231.

SEC. 202. *Gross income of life insurance companies.*—(a) In the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents. For inclusion in computation of tax of amount specified in shareholder's consent, see section 28.

(b) The term "reserve funds required by law" includes, in the case of assessment insurance, sums actually deposited by any company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation of the company or association exclusively for the payment of claims, arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

SEC. 203. *Net income of life insurance companies.*—(a) *General rule.*—In the case of a life insurance company the term "net income" means the gross income less—

ART. 203 (a)–1. *Limitation on deductions.*—In addition to the limitations on deductions hereinafter specifically referred to, life insurance companies are subject to the limitation provided in section 24 (a) (5).

[SEC. 203. *Net income of life insurance companies.*]

[(a) *General rule.*—In the case of a life insurance company the term "net income" means the gross income less—]

(1) *Tax-free interest.*—The amount of interest received during the taxable year which under section 22 (b) (4) is excluded from gross income;

ART. 203 (a) (1)–1. *Tax-free interest.*—Interest which in the case of other taxpayers is excluded from gross income by section 22 (b) (4) but included in the gross income of a life insurance company by section 202 (a) is allowed as a deduction from gross income by section 203 (a) (1).

[SEC. 203. *Net income of life insurance companies.*]

[(a) *General rule.*—In the case of a life insurance company the term "net income" means the gross income less—]

(2) *Reserve funds.*—An amount equal to 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ per centum shall be substituted for 4 per centum. Life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, shall be allowed, in addition to the above, a deduction of 3¾ per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

ART. 203 (a) (2)–1. *Reserve funds.*—In general, the reserve contemplated is a sum of money, variously computed or estimated, which, with accretions from interest, is set aside (reserved) as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future unaccrued and contingent claims. It must be required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, but such requirement, without more, is not conclusive; for example, it does not include reserves required to be maintained to provide for the ordinary running expenses of a business definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance and unpaid brokerage; the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance; reserve for premiums paid in advance; annual and deferred dividends; accrued but unsettled policy claims; losses incurred but unreported; liability on supplementary contracts not involving life contingencies; estimated value of future premiums which have been waived on policies after proof of total and permanent disability.

In any case where reserves are claimed, sufficient information must be filed with the return to enable the Commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the statute or insurance department ruling requiring that such reserves be held. Only reserves which are so required, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will be considered. A company is permitted to make use of the highest aggregate reserve called for by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserve funds thereon be based upon recognized tables of experience covering disability benefits of the kind contained in policies issued by this particular class of companies. The deduction in respect of such reserve funds (not required by law) is 3¾ percent of the mean of such reserve funds held at the beginning and end of the taxable year.

[SEC. 203. *Net income of life insurance companies.*]

[(a) *General rule.*—In the case of a life insurance company the term "net income" means the gross income less—]

(3) *Reserve for dividends.*—An amount equal to 2 per centum of any sums held at the end of the taxable year as a reserve for dividends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than five years from the date of the policy contract;

(4) *Investment expenses.*—Investment expenses paid during the taxable year: *Provided*, That if any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year;

ART. 203 (a) (4)–1. *Investment expenses.*—The term "general expenses" as used in the Act means any expense incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. Any assignment of such expense to the investment department of the company for which a deduction is claimed under section 203 (a) (4) shall operate to subject the total investment expenses to the limitation provided in that section.

If no general expenses are assigned to or included in investment expenses the deduction may consist of investment expenses actually paid during the taxable year in which case an itemized schedule of such expenses must be appended to the return.

Invested assets for the purpose of section 203 (a) (4) and this article are those which are owned and used, and to the extent used, for the purpose of producing the income specified in section 202 (a).

The maximum allowance of one-fourth of 1 percent will not be granted unless it is shown to the satisfaction of the Commissioner that such allowance is justified.

[SEC. 203. *Net income of life insurance companies.*]

[(*a*) *General rule.*—In the case of a life insurance company the term "net income" means the gross income less—]

(5) *Real estate expenses.*—Taxes and other expenses paid during the taxable year exclusively upon or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder of a company upon his interest as shareholder, which are paid by the company without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes;

ART. 203 (a) (5)-1. *Taxes and expenses with respect to real estate.*—The deduction for taxes and expenses under section 203 (a) (5) includes taxes and expenses paid during the taxable year exclusively upon or with respect to real estate owned by the company and any sum representing taxes imposed upon a shareholder of the company upon his interest as shareholder which is paid by the company without reimbursement from the shareholders. No deduction shall be allowed, however, for taxes, expenses, and depreciation upon or with respect to any real estate owned by the company except to the extent used for the purpose of producing investment income. (See article 203 (a) (4)-1.) As to real estate owned and occupied by the company see article 203 (b)-1.

[SEC. 203. *Net income of life insurance companies.*]

[(*a*) *General rule.*—In the case of a life insurance company the term "net income" means the gross income less—]

(6) *Depreciation.*—A reasonable allowance, as provided in section 23 (l), for the exhaustion, wear and tear of property, including a reasonable allowance for obsolescence; and

ART. 203 (a) (6)-1. *Depreciation.*—The deduction allowed by section 203 (a) (6) for depreciation is, except as provided in article 203 (b)-1, identified with that allowed other corporations by section 23 (l). The amount allowed by section 23 (l) in the case of life insurance companies is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 202 (a).

[SEC. 203. *Net income of life insurance companies.*]

[(*a*) *General rule.*—In the case of a life insurance company the term "net income" means the gross income less—]

(7) *Interest.*—All interest paid within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title.

ART. 203 (a) (7)-1. *Interest.*—The deduction allowed by section 203 (a) (7) for interest on indebtedness is the same as that allowed other corporations by section 23 (b) but this deduction includes interest on dividends held on deposit and surrendered during the taxable year. Reserve funds as defined in article 203 (a) (2)-1 are not indebtedness. Dividends left with the company to accumulate at interest are a debt and not a reserve liability.

If a life insurance company pays interest on the proceeds of life insurance policies left with it pursuant to the provisions of supplementary contracts, not involving life contingencies, or similar contracts, the interest so paid shall be allowed as a deduction from gross income, except that such deduction shall not be allowed in respect of interest accrued in any prior taxable year to the extent that the company has had the benefit of a deduction of 4 percent or 3¾ percent, as the case may be, of the mean of the company's liability on such contracts, by the inclusion of such liability in its reserve funds.

[SEC. 203. *Net income of life insurance companies.*]

(*b*) *Rental value of real estate.*—The deduction under subsection (a) (5) or (6) of this section on account of any real estate owned and occupied in whole or in part by a life insurance company, shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this subsection) as the rental value of the space not so occupied bears to the rental value of the entire property.

ART. 203 (b)-1. *Real estate owned and occupied.*—The amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a life insurance company is limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this article, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

SEC. 204. *Insurance companies other than life or mutual.*—(*a*) *Imposition of tax.*—(1) *In general.*—In lieu of the tax imposed by sections 13 and 14, there shall be levied, collected, and paid for each taxable year upon the special class net income of every insurance company (other than a life or mutual insurance company) a tax of 16½ per centum of the amount thereof.

(2) *Special class net income of foreign companies.*—In the case of a foreign insurance company (other than a life or mutual insurance company), the special class net income shall be the net income from sources within the United States minus the sum of—

(A) *Interest on obligations of the United States and its instrumentalities.*—The credit provided in section 26 (a).

(B) *Dividends received.*—The credit provided in section 26 (b).

(3) *No United States insurance business.*—Foreign insurance companies not carrying on an insurance business within the United States shall not be taxable under this section but shall be taxable as other foreign corporations.

ART. 204 (a)-1. *Tax on insurance companies other than life or mutual.*—All insurance companies (other than life or mutual companies or foreign insurance companies not carrying on an insurance business within the United States) are subject to the tax imposed by section 204. The term "insurance companies" as used in this article and in articles 204 (b)-1 and 204 (c)-1 means only those companies subject to the tax imposed by section 204. The rate of the tax imposed by section 204 is 16½ percent and the tax is imposed upon the special class net income as defined in section 14. The net income of insurance companies other than life or mutual is defined in section 204 and differs from the net income of other corporations. All provisions of the Act and of these regulations not inconsistent with the specific provisions of section 204 are applicable to the assessment and collection of the tax imposed by section 204 (a), and insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. Since section 204 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the first returns under section 204 will be for the taxable year ending December 31, 1938, and shall be on Form 1120. Insurance companies are entitled to the credits provided in section 26 (a) and (b).

Foreign insurance companies not carrying on an insurance business within the United States are not taxable under section 204 but are taxable as other foreign corporations. See section 231.

[SEC. 204. *Insurance companies other than life or mutual.*]

(*b*) *Definition of income, etc.*—In the case of an insurance company subject to the tax imposed by this section—

(1) *Gross income.*—"Gross income" means the sum of (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, and (B) gain during the taxable year from the sale or other disposition of property, and (C) all other items constituting gross income under section 22;

(2) *Net income.*—"Net income" means the gross income as defined in paragraph (1) of this subsection less the deductions allowed by subsection (c) of this section;

(3) *Investment income.*—"Investment income" means the gross amount of income earned during the taxable year from interest, dividends, and rents, computed as follows:

To all interest, dividends and rents received during the taxable year, add interest, dividends and rents due and accrued at the end of the taxable year, and deduct all interest, dividends and rents due and accrued at the end of the preceding taxable year:

(4) *Underwriting income.*—"Underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;

(5) *Premiums earned.*—"Premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year;

(6) *Losses incurred.*—"Losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the result so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year;

(7) *Expenses incurred.*—"Expenses incurred" means all expenses shown on the annual statement approved by the National Convention of Insurance Commissioners, and shall be computed as follows:

To all expenses paid during the taxable year add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the net income subject to the tax imposed by this section there shall be deducted from expenses incurred as defined in this paragraph all expenses incurred which are not allowed as deductions by subsection (c) of this section.

ART. 204 (b)-1. *Gross income of insurance companies other than life or mutual.*—Gross income as defined in section 204 (b) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from the sale or other disposition of property, and all other items constituting gross income under section 22. See section 22 (a), (b), and (c) and sections 28 and 334. It does not include increase in liabilities during the year on account of reinsurance treaties, remittances from home office of a foreign insurance company to the United States branch, borrowed money, gross increase due to adjustments in book value of capital assets, and premium on capital stock sold. The underwriting and investment exhibit is presumed clearly to reflect the true net income of the company, and in so far as it is not inconsistent with the provisions of the Act will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Act. By reason of the definition of investment income, miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared, home office remittances and receipts, and special deposits, are ignored. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been charged off the books of the company as bad debts or, having been previously charged off, are recovered during the taxable year.

[SEC. 204. *Insurance companies other than life or mutual.*]

(c) *Deductions allowed.*—In computing the net income of an insurance company subject to the tax imposed by this section there shall be allowed as deductions:

(1) All ordinary and necessary expenses incurred, as provided in section 23 (a);

(2) All interest as provided in section 23 (b);

(3) Taxes as provided in section 23 (c);

(4) Losses incurred as defined in subsection (b) (6) of this section;

(5) Subject to the limitation contained in section 117 (d), losses sustained during the taxable year from the sale or other disposition of property;

(6) Bad debts in the nature of agency balances and bills receivable ascertained to be worthless and charged off within the taxable year;

(7) The amount of interest earned during the taxable year which under section 22 (b) (4) is excluded from gross income;

(8) A reasonable allowance for the exhaustion, wear and tear of property, as provided in section 23 (l);

(9) Charitable, and so forth, contributions, as provided in section 23 (q);

(10) Deductions (other than those specified in this subsection) as provided in section 23, but not in excess of the amount of the gross income included under subsection (b) (1) (C) of this section.

(d) *Deductions of foreign corporations.*—In the case of a foreign corporation the deductions allowed in this section shall be allowed to the extent provided in Supplement I in the case of a foreign corporation engaged in trade or business within the United States or having an office or place of business therein.

(e) *Double deductions.*—Nothing in this section shall be construed to permit the same item to be twice deducted.

ART. 204 (c)-1. *Deductions allowed insurance companies other than life or mutual.*—The deductions allowable are specified in section 204, but are subject to the limitation provided in section 24 (a) (5).

Among the items which may not be deducted are income and profits taxes imposed by the United States, income and profits taxes imposed by any foreign country or possession of the United States (in cases where the company signifies in its return its desire to claim to any extent a credit for such taxes), taxes assessed against local benefits, donations, decrease during the year due to adjustments in the book value of capital assets, decrease in liabilities during the year on account of reinsurance treaties, dividends paid to shareholders, remittances to the home office of a foreign insurance company by the United States branch, and borrowed money repaid.

In computing net income of insurance companies other than life or mutual losses sustained during the taxable year from the sale or other disposition of property are deductible subject to the limitation contained in section 117 (d) but the graduated percentage reduction of gains and losses contained in section 117 (b) does not apply in the case of insurance (or other) corporations. Insurance companies conducting their business in such manner as to receive income under section 204 (b) (1) (C) are entitled to such deductions relating thereto as are provided for in section 204 (c), but, in the case of deductions referred to in section 204 (c) (10), only to the extent that the aggregate amount thereof does not exceed the income included under section 204 (b) (1) (C).

SEC. 205. *Taxes of foreign countries and possessions of United States.*—The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of a domestic insurance company subject to the tax imposed by section 201, 204, or 207, to the extent provided in the case of a domestic corporation in section 131, and in the case of the tax imposed by section 201 or 204 "net income" as used in section 131 means the net income as defined in this Supplement.

SEC. 206. *Computation of gross income.*—The gross income of insurance companies subject to the tax imposed by section 201 or 204 shall not be determined in the manner provided in section 119.

SEC. 207. *Mutual insurance companies other than life.*—(a) *Imposition of tax.*—

(1) *In general.*—There shall be levied, collected, and paid for each taxable year upon the special class net income of every mutual insurance company (other than a life insurance company) a tax equal to 16½ per centum thereof.

(2) *Foreign corporations.*—The tax imposed by paragraph (1) shall apply to foreign corporations as well as domestic corporations; but foreign insurance companies not carrying on an insurance business within the United States shall be taxable as other foreign corporations.

(b) *Gross income.*—Mutual marine-insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance.

(c) *Deductions.*—In addition to the deductions allowed to corporations by section 23 the following deductions to insurance companies shall also be allowed, unless otherwise allowed—

(1) *Mutual insurance companies other than life insurance.*—In the case of mutual insurance companies other than life insurance companies—

(A) the net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and

(B) the sums other than dividends paid within the taxable year on policy and annuity contracts.

(2) *Mutual marine insurance companies.*—In the case of mutual marine insurance companies, in addition to the deductions allowed in paragraph (1) of this subsection, unless otherwise allowed, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof;

(3) *Mutual insurance companies other than life and marine.*—In the case of mu-

tual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves.

ART. 207-1. *Tax on mutual insurance companies other than life.*—All mutual insurance companies other than life (including foreign insurance companies carrying on an insurance business within the United States) are subject to the tax imposed by section 207 and the rate of tax is 16½ percent. The tax is imposed upon the special class net income as defined in section 14. The net income of mutual insurance companies differs from the net income of other corporations.

Foreign insurance companies not carrying on an insurance business within the United States are not taxable under section 207 but are taxable as other foreign corporations. See section 231.

ART. 207-3. *Gross income of mutual insurance companies other than life.*—The gross income of mutual insurance companies (other than life) consists of their total revenue from the operation of the business and of their income from all other sources within the taxable year, except as otherwise provided by the Act. Gross income includes net premiums (that is, gross premiums less returned premiums on policies canceled and premiums on policies not taken), investment income, profits from the sale of assets, and all gains, profits, and income reported to the State insurance departments, except income specifically exempt from tax. Premiums received by mutual marine insurance companies which are paid out for reinsurance should be eliminated from gross income and the payments for reinsurance from disbursements. Deposit premiums on perpetual risks received and returned by mutual fire insurance companies should be treated in the same manner, as no reserve will be recognized covering liability for such deposits. The earnings on such deposits, including such portion, if any, of the deposits as is not returned to the policyholders upon cancellation of the policies, must be included in the gross income. A net decrease in reserve funds required by law within the taxable year must be included in the gross income to the extent that such funds are released to the general uses of the company and increase its free assets. Any net decrease in reserves shall be added to the gross income, unless the company shall show that such decrease resulted from the application of reserves to the purposes for which they were established.

ART. 207-3. *Deductions allowed mutual insurance companies other than life insurance companies.*—Mutual insurance companies (other than life insurance companies) are entitled to the same deductions from gross income as other corporations, and also to the deduction of the net addition required by law to be made within the taxable year to reserve funds and of the sums other than dividends paid within the taxable year on policy and annuity contracts. Mutual insurance companies are not entitled to the deductions allowed by section 204 (c), but (except in the case of life insurance companies) are entitled to the deductions allowed by section 23. "Paid" includes "accrued" or "incurred" (construed according to the method of accounting upon the basis of which the net income is computed) during the taxable year, but does not include any estimate for losses incurred but not reported during the taxable year.

ART. 207-4. *Required addition to reserve funds of mutual insurance companies (other than life).*—Mutual insurance companies, other than life insurance companies, may deduct from gross income the net addition required by law to be made within the taxable year to reserve funds, including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds. Reserve funds "required by law" include not only reserves required by express statutory provisions but also reserves required by the rules and regulations of State insurance departments when promulgated in the exercise of an appropriate power conferred by statute, but do not include assets required to be held for the ordinary running expenses of the business, such as taxes, salaries, reinsurance, and unpaid brokerage. Only reserves commonly recognized as reserve funds in insurance accounting are to be taken into consideration in computing the net addition to reserve funds required by law. In the case of a fire insurance company the only reserve fund commonly recognized is the "unearned-premium" fund. For a general definition of "reserve fund" see article 203 (a) (2)-1. Mutual hail and mutual cyclone insurance companies are entitled to deduct from gross income the net addition which they are required to make to the "guarantee surplus" fund or similar fund. In the case of foreign insurance companies the deductions provided for by section 207 shall be allowed to the extent provided in Supplement I in the case of a foreign corporation engaged in trade or business within the United States or having an office or place of business therein.

ART. 207-5. *Special deductions allowed mutual marine insurance companies.*—Mutual marine insurance companies should include in gross income the gross premiums collected and received by them less amounts paid for reinsurance. They may deduct from gross income amounts repaid to policyholders on account of premiums previously paid by them, together with the interest actually paid upon such amounts between the date of ascertainment and the date of payment thereof. The remainder of the premiums accordingly forms part of the net income of the company, except to the extent that it is subject to the deductions allowed such insurance companies and other corporations.

ART. 207-6. *Special deductions allowed mutual insurance companies (other than life or marine).*—Mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life and mutual marine insurance companies), which require their members to make premium deposits to provide for losses and expenses, are allowed to deduct from gross income the aggregate amount of premium deposits returned to their policyholders or retained for the payment of losses, expenses, and reinsurance reserves. In determining the amount of premium deposits retained by a mutual fire or mutual casualty insurance company for the payment of losses, expenses, and reinsurance reserves, it will be presumed that losses and expenses have been paid out of earnings and profits other than premiums to the extent of such earnings and profits. If, however, any portion of such amount is applied during the taxable year to the payment of losses, expenses, or reinsurance reserves, for which a separate allowance is taken, then such portion is not deductible; and if any portion of such amount for which an allowance is taken is subsequently applied to the payment of expenses, losses, or reinsurance reserves, then such payment cannot be separately deducted. The amount of premium deposits retained for the payment of expenses and losses, and the amount of such expenses and losses, may not both be deducted. A company which invests part of the premium deposits so retained by it in interest-bearing securities may nevertheless deduct such part, but not the interest received on such securities. A mutual fire insurance company which has a guaranty capital is taxed like other mutual fire insurance companies. A stock fire insurance company, operated on the mutual plan to the extent of paying dividends to certain classes of policyholders, may make a return on the same basis as a mutual fire insurance company with respect to its business conducted on the mutual plan.

ART. 207-7. *Returns of mutual insurance companies (other than life).*—Mutual insurance companies other than life (including foreign insurance companies carrying on an insurance business within the United States) are required to file returns of income. The return shall be on Form 1120. As an aid in auditing the returns, wherever possible a copy of the report to the State insurance department should be submitted with the return. Otherwise a copy of Schedule D, parts 1, 3, and 4, of the report should be attached to the return, showing the Federal, State, and municipal obligations from which the interest omitted from gross income was derived, and a copy of the complete report should be furnished as soon as ready for filing. All provisions of the Act and these regulations not inconsistent with the specific provisions of section 207 are applicable to the assessment and collection of the tax imposed by section 207, and mutual insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations.

CHAPTER XXVI

Nonresident Aliens

Supplement H—Nonresident Alien Individuals

SEC. 211 *Tax on nonresident alien individuals.—(a) No United States business or office.—(1) General rule.*—There shall be levied, collected, and paid for each taxable year, in lieu of the tax imposed by sections 11 and 12, upon the amount received, by every nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein, from sources within the United States as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, a tax of 10 per centum of such amount, except that such rate shall be reduced, in the case of a resident of a contiguous country, to such rate (not less than 5 per centum) as may be, provided by treaty with such country. For inclusion in computation of tax of amount specified in shareholder's consent, see section 28.

(2) *Aggregate more than $21,600.*—The tax imposed by paragraph (1) shall not apply to any individual if the aggregate amount received during the taxable year from the sources therein specified is more than $21,600.

(3) *Residents of contiguous countries.*—Despite the provisions of paragraph (2), the provisions of paragraph (1) shall apply to a resident of a contiguous country so long as there is in effect a treaty with such country (ratified prior to August 26, 1937) under which the rate of tax under section 211 (a) of the Revenue Act of 1936, prior to its amendment by section 501 (a) of the Revenue Act of 1937, was reduced.

(b) *United States business or office.*—A nonresident alien individual engaged in trade or business in the United States or having an office or place of business therein shall be taxable without regard to the provisions of subsection (a). As used in this section, section 119, section 143, section 144, and section 231, the phrase "engaged in trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year, but does not include the performance of personal services for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of ninety days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000. Such phrase does not include the effecting of transactions in the United States in stocks, securities, or commodities through a resident broker, commission agent, or custodian.

(c) *No United States business or office and gross income of more than $21,600.*—A nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein who has a gross income for any taxable year of more than $21,600 from the sources specified in subsection (a) (1), shall be taxable without regard to the provisions of subsection (a) (1), except that—

(1) The gross income shall include only income from the sources specified in subsection (a) (1);

(2) The deductions (other than the so-called "charitable deduction" provided in section 213 (c)) shall be allowed only if and to the extent that they are properly allocable to the gross income from the sources specified in subsection (a) (1);

(3) The aggregate of the normal tax and surtax under sections 11 and 12 shall, in no case, be less than 10 per centum of the gross income from the sources specified in subsection (a) (1); and

(4) This subsection shall not apply to a resident of a contiguous country so long as there is in effect a treaty with such country (ratified prior to August 26, 1937) under which the rate of tax under section 211 (a) of the Revenue Act of 1936, prior to its amendment by section 501 (a) of the Revenue Act of 1937, was reduced.

ART. 211-1. *Taxation of aliens in general.*—For the purposes of the Act alien individuals are divided generally into two classes, namely, resident aliens and nonresident aliens. Resident aliens are in general taxable the same as citizens of the United States, that is, a resident alien is taxable on income derived from all sources including sources without the United States. Nonresident aliens are taxable only on income from sources within the United States. For classification of nonresident aliens, see article 211-7.

ART. 211-2. *Definition.*—A "nonresident alien individual" means an individual—

(*a*) Whose residence is not within the United States; and

(*b*) Who is not a citizen of the United States.

The term includes a nonresident alien fiduciary.

An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abondoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this article, in the absence of exceptional circumstances.

ART. 211-3. *Alien seamen, when to be regarded as residents.*—In order to determine whether an alien seaman is a resident within the meaning of the income tax law, it is necessary to decide whether the presumption of nonresidence is overcome by facts showing that he has established a residence in the United States. Residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel flying the United States flag and engaged in foreign trade is not sufficient to establish residence in the United States, even though the vessel, while carrying on foreign trade, touches at American ports. An alien seaman may acquire an actual residence in the United States within the rules laid down in article 211-4, although the nature of his calling requires him to be absent for a long period from the place where his residence is established. An alien seaman may acquire such a residence at a sailors' boarding house or hotel, but such a claim should be carefully scrutinized in order to make sure that such residence is bona fide. The filing of Form 1078 or taking out first citizenship papers is proof of residence in the United States from the time the form is filed or the papers taken out, unless rebutted by other evidence showing an intention to be a transient. The fact that a head tax has been paid on behalf of an alien seaman entering the United States is no evidence that he has acquired residence, because the head tax is payable unless the alien who is entering the country is merely in transit through the country.

ART. 211-4. *Proof of residence of alien.*—The following rules of evidence shall govern in determining whether or not an alien within the United States has acquired residence therein within the meaning of the Act. An alien, by reason of his alienage, is presumed to be a nonresident alien. Such presumption may be overcome—

(1) In the case of an alien who presents himself for determination of tax liability prior to departure for his native country, by (*a*) proof that the alien, at least six months prior to the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (*b*) proof that the alien, at least six months prior to the date he so presents himself, has filed Form 1078 or its equivalent, or (*c*) proof of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident;

(2) In other cases by (*a*) proof that the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (*b*) proof that the alien has filed Form 1078 or its equivalent, or (*c*) proof

of acts and statements of an alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

In any case in which an alien seeks to overcome the presumption of nonresidence under (1) (*c*) or (2) (*c*), if the internal-revenue officer who examines the alien is in doubt as to the facts, such officer may, to assist him in determining the facts, require an affidavit or affidavits setting forth the facts relied upon, executed by some credible person or persons, other than the alien and members of his family, who have known the alien at least six months prior to the date of execution of the affidavit or affidavits.

ART. 211-5. *Loss of residence by alien.*—An alien who has acquired residence in the United States retains his status as a resident until he abandons the same and actually departs from the United States. An intention to change his residence does not change his status as a resident alien to that of a nonresident alien. Thus an alien who has acquired a residence in the United States is taxable as a resident for the remainder of his stay in the United States.

ART. 211-6. *Duty of employer to determine status of alien employee.*—If wages are paid to aliens without withholding the tax, except as permitted in article 143-3, in the case of a resident of Canada or Mexico, the employer should be prepared to prove the status of the alien as provided in the foregoing articles. An employer may rely upon the evidence of residence afforded by the fact that an alien has filed Form 1078, or an equivalent certificate of the alien establishing residence. An employer need not secure Form 1078 from the alien if he is satisfied that the alien is a resident alien. An employer who seeks to account for failure to withhold in the past, if he had not at the time secured Form 1078 or its equivalent, is permitted to prove the former status of the alien by any competent evidence. The written statement of the alien employee may ordinarily be relied upon by the employer as proof that the alien is a resident of the United States.

ART. 211-7. *Taxation of nonresident alien individuals.*—For the purposes of this article and articles 212-1, 213-1, 214-1, and 217-2, nonresident alien individuals are divided into three classes: (1) nonresident alien individuals not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year and deriving in the taxable year not more than $21,600 gross amount of fixed or determinable annual or periodical income from sources within the United States; (2) nonresident alien individuals not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year and deriving in the taxable year more than $21,600 gross amount of fixed or determinable annual or periodical income from sources within the United States; and (3) nonresident alien individuals who at any time during the taxable year are engaged in trade or business in the United States or have an office or place of business therein.

(*a*) *No United States business or office—General rule.*—A nonresident alien individual within class (1) referred to in the preceding paragraph is liable to the tax upon the amount received from sources within the United States, determined under the provisions of section 119, which is fixed or determinable annual or periodical gains, profits, and income. For the purposes of section 211 (a), the term "amount received" means "gross income." Specific items of fixed or determinable annual or periodical income are enumerated in the Act as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensation, remunerations, and emoluments, but other fixed or determinable annual or periodical gains, profits, and income are also subject to the tax, as, for instance, royalties. As to the determination of fixed or determinable annual or periodical income, see article 143-2. The items of fixed or determinable annual or periodical income from sources within the United States received by a citizen of France residing in France which are exempt from Federal income taxation under the provisions of the tax convention between the United States and France signed April 27, 1932, and effective January 1, 1936 (see page 680 of the Appendix to these regulations), are described in article 143-3.

The fixed or determinable annual or periodical income from sources within the United States of a nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year and deriving in the taxable year not more than $21,600 gross amount of fixed or determinable annual or periodical income from sources within the United States, is taxable at the rate of 10 percent, except that such rate shall be reduced, in the case of a resident of a contiguous country, to such rate (not less than 5 percent) as may be provided by treaty with such country. (See also article 212-1.) Under the terms of the tax convention between the United States and Canada, signed December 30, 1936, and effective January 1, 1936, the tax at the rate of 10 percent imposed by section 211 (a) is reduced to 5 percent in the case of a nonresident alien individual who is a resident of Canada. (See page 668 of the Appendix to these regulations.)

(*b*) *No United States business or office.—Aggregate more than $21,600.*—A nonresident alien individual within class (2) referred to in the first paragraph of this article is, under the provisions of section 211 (c), subject to tax only upon his fixed or determinable annual or periodical income specified in section 211 (a) determined under the provisions of section 119, minus (1) the deductions properly allocable to such income and (2) the so-called "charitable contributions" deduction provided in section 213 (c). Such nonresident alien is entitled to the credits against net income allowable to an individual by section 25, subject to the limitations provided in section 214. However, the tax thus computed under sections 11 and 12 shall in no such case be less than 10 percent of the gross amount of such fixed or determinable annual or periodical income from sources within the United States. Nonresident alien individuals, residents of Canada, are not affected by the provisions of section 211 (c) or of this paragraph but are (under the terms of the tax convention between the United States and Canada) subject to tax under the provisions of section 211 (a) and the special provisions of paragraph (*a*) of this article relating to such aliens.

(*c*) *United States business or office.*—A nonresident alien individual within class (3), referred to in the first paragraph of this article, is not taxable at the rate of 10 percent upon the items of gross income enumerated in section 211 (a). The net income from sources within the United States of such a nonresident alien individual (gross income from sources within the United States minus the statutory deductions provided in sections 23 and 213) less the credits against net income allowable to an individual by section 25, is subject to the normal tax of 4 percent imposed by section 11 and the graduated surtax imposed by section 12 (b).

As used in sections 211, 119, 143, 144, and 231, the phrase "engaged in trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year but does not include the performance of personal services for a nonresident alien individual, foreign partnership, or foreign corporation not engaged in trade or business within the United States by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000. Such phrase does not include the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian. (See also article 212-1.)

Whether a nonresident alien has an "office or place of business" within the United States depends upon the facts in a particular case. The term "office or place of business," however, implies a place for the regular transaction of business and does not include a place where casual or incidental transactions might be, or are, effected.

Neither the beneficiary nor the grantor of a trust, whether revocable or irrevocable, is deemed to be engaged in trade or business in the United States or to have an office or place of business therein, merely because the trustee is engaged in trade or business in the United States or has an office or place of business therein.

SEC. 212. *Gross income.—(a) General rule.*—In the case of a nonresident alien individual gross income includes only the gross income from sources within the United States.

(b) *Ships under foreign flag.*—The income of a nonresident alien individual which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States shall not be included in gross income and shall be exempt from taxation under this title.

ART. 212–1. *Gross income of nonresident individuals.*—In general, in the case of nonresident alien individuals "gross income" means only the gross income from sources within the United States, determined under the provisions of section 119. (See articles 119–1 to 119–14.) The items of gross income from sources without the United States and therefore not taxable to nonresident aliens are described in section 119 (c). As to who are nonresident alien individuals see articles 211–2 to 211–6.

Income received by a resident alien from sources without the United States is taxable although such person may become a nonresident alien subsequent to its receipt and prior to the close of the taxable year. Conversely, income received by a nonresident alien from sources without the United States is not taxable though such person may become a resident alien subsequent to its receipt and prior to the close of the taxable year.

(a) *No United States business or office.*—The gross income of a nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year, whether such alien comes within section 211 (a) or section 211 (c), is gross income from sources within the United States consisting of fixed or determinable annual or periodical income. His taxable income does not include profits derived from the effecting of transactions in the United States in stocks, securities or commodities (including hedging transactions) through a resident broker, commission agent, or custodian, or profits derived from the sale within the United States of personal property or real property located therein.

(b) *United States business or office.*—The gross income of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States or had an office or place of business therein is not limited to the items of gross income specified in section 211 (a), but includes any item of gross income which is treated as income from sources within the United States, except those items which are exempt from taxation by statute or treaty or which are not taxable by the Federal Government under the Constitution. (See sections 22 (b), 112, 116, 119, and 212 (b).)

In general, any nonresident alien individual who performs personal services within the United States is considered as being engaged in trade or business within the United States and therefore his net income from sources within the United States, including his compensation, is subject to the normal tax of 4 percent and the surtax. However, the phrase "engaged in trade or business within the United States" does not apply to the personal services performed within the United States for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000. Such compensation is not income from sources within the United States. (See section 119 (a) (3).) As to the exclusion from gross income of the official compensation received by employees of foreign governments see section 116 (h).

The effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian does not bring a nonresident alien individual within the class of nonresident alien individuals engaged in trade or business within the United States, but if a nonresident alien individual by reason of rendering personal services in the United States, or for other reasons, is classed as a nonresident alien individual engaged in trade or business within the United States or having an office or place of business therein, he is taxable upon all income from sources within the United States, including profits derived from the effecting of such transactions. Such a nonresident alien individual is required to include in gross income capital gains, gains from hedging transactions, and profits derived from the sale within the United States of personal property, or of real property located therein.

ART. 212–2. *Exclusion of earnings of foreign ships from gross income.*—So much of the income from sources within the United States of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States, or had an office or place of business therein as consists of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in such foreign country and to corporations organized in the United States, shall not be included in gross income. Foreign countries which either impose no income tax, or, in imposing such tax, exempt from taxation so much of the income of a citizen of the United States nonresident in such foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States are considered as granting an equivalent exemption within the meaning of this article.

A nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein at any time within the taxable year is not required to include in gross income such income from sources within the United States as is derived from the operation of a ship or ships, whether or not the foreign country under the laws of which such ships are documented meets the equivalent exemption requirements of the statute.

SEC. 213. *Deductions.—(a) General rule.*—In the case of a nonresident alien individual the deductions shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in section 119, under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

(b) *Losses.*—(1) The deduction, for losses not connected with the trade or business if incurred in transactions entered into for profit, allowed by section 23 (e) (2) shall be allowed whether or not connected with income from sources within the United States, but only if the profit, if such transaction had resulted in a profit, would be taxable under this title.

(2) The deduction for losses of property not connected with the trade or business if arising from certain casualties or theft, allowed by section 23 (e) (3), shall be allowed whether or not connected with income from sources within the United States, but only if the loss is of property within the United States.

(c) *Charitable, etc., contributions.*—The so-called "charitable contribution" deduction allowed by section 23 (o) shall be allowed whether or not connected with income from sources within the United States, but only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States, or to the vocational rehabilitation fund.

ART. 213–1. *Deductions allowed nonresident alien individuals.—(a) No United States business or office.*—(1) *General rule.*—In general, a nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year is not allowed any deductions, the tax being imposed upon the amount of gross income received.

(2) *Aggregate more than $21,600.*—A nonresident alien individual (other than a resident of Canada) not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year but deriving for such year more than $21,600 gross amount of fixed or determinable annual or periodical income from sources within the United States is allowed for such year only such deductions as are properly allocable to such income. He is also allowed the contributions or gifts made within the taxable year whether or not connected with income from sources within the United States but only if made to domestic corporations or to community chests, funds, or foundations created in the United States of the type specified in section 23 (o), or to the vocational rehabilitation fund, subject to the limitations provided in section 23 (o).

(b) *United States business or office.*—In the case of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States or had an office or place of business therein the deductions allowed by section 23 for business expenses, interest, taxes, losses in trade, bad debts, depreciation, and depletion are allowed only if and to the extent that they are connected with income from sources within the United States. (See also section 215.) In the case of such taxpayers, however, (1) losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, although not connected with the trade or business, are (if otherwise allowable) deductible only if and to the extent that the profit, if such transaction had resulted in a profit, would have been taxable as income from sources within the United States; (2) losses sustained during the taxable year of property not connected with the trade or business if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise, are deductible only if the property was located within the United States; and (3) contributions or gifts made within the taxable year are deductible, only if made to domestic corporations or to community chests, funds, or foundations, created in the United States, of the type specified in section 23 (o), or to the vocational rehabilitation fund, subject to the limitation provided in section 23 (o).

Losses embraced under clause (2) of the preceding pargraph are deductible in full from items of gross income specified as being derived in full from sources within the United States, and, if greater than the sum of such items, the unabsorbed loss may be deducted from the income apportioned to sources within the United States under the provisions of article 119-12. Losses embraced under clause (1) are deductible in full (as provided in article 119-10 or article 119-11) when the profit from the transaction, if it had resulted in a profit, would have been taxable in full as income from sources within the United States, but should be deducted under the provisions of article 119-12 when the profit from the transaction, if it had resulted in profit, would have been taxable only in part.

SEC. 214. *Credits against net income.* In the case of a nonresident alien individual the personal exemption allowed by section 25 (b) (1) of this title shall be only $1,000. The credit for dependents allowed by section 25 (b) (2) shall not be allowed in the case of a nonresident alien individual unless he is a resident of a contiguous country.

ART. 214-1. *Credits to nonresident alien individuals.*—(a) *No United States business or office.*—(1) *General rule*—In general, a nonresident alien individual not engaged in trade or business in the United States and not having an office or place of business therein at any time during the taxable year is not allowed any credits under section 25, the tax being imposed upon the amount of gross income received.

(2) *Aggregate more than $21,600.*—In the case of a nonresident alien individual (other than a resident of Canada) not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year and deriving in such year gross amount of fixed or determinable annual or periodical income from sources within the United States of more than $21,600, the credits allowed are those applicable in the case of nonresident alien individuals engaged in trade or business within the United States or having an office or place of business therein.

(b) *United States business or office.*—In the case of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States or had an office or place of business therein, the personal exemption allowed as a credit against net income by section 25 (b) (1) shall be $1,000, whether such alien is a single person, a married person living with husband or wife, or the head of a family. The credit for dependents provided by section 25 (b) (2) is allowed to nonresident alien individuals who at any time within the taxable year were engaged in trade or business within the United States or had an office or place of business therein only if they are residents of Canada or Mexico. If the status of the taxpayer as to dependents changes during the taxable year, the credit for dependents shall be determined as provided in article 25-7.

SEC. 215. *Allowance of deductions and credits.*—(a) *Return to contain information.*—A nonresident alien individual shall receive the benefit of the deductions and credits allowed to him in this title only by filing or causing to be filed with the collector a true and accurate return of his total income received from all sources in the United States, in the manner prescribed in this title; including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits.

(b) *Tax withheld at source.*—The benefit of the personal exemption and credit for dependents may, in the discretion of the Commissioner and under regulations prescribed by him with the approval of the Secretary, be received by a nonresident alien individual entitled thereto, by filing a claim therefor with the withholding agent.

ART. 215-1. *Allowance of deductions and credits to nonresident alien individuals*—(a) *No United States business or office*—(1) *General rule.*—In general, a nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year is not entitled to any allowance of deductions or credits even though he may file a return of income.

(2) *Aggregate more than $21,600.*—Unless a nonresident alien individual (other than a resident of Canada) not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year and having, for such year from sources within the United States, fixed or determinable annual or periodical income in a gross amount of more than $21,600, shall file or cause to be filed with the collector a true and accurate return of his total fixed or determinable annual or periodical income from sources within the United States as required by paragraph (a) (2) of article 217-2, the tax shall be collected on the basis of gross amount of such fixed or determinable annual or periodical income. Where such nonresident alien has various sources of fixed or determinable annual or periodical income from within the United States, as, for instance, from an estate or trust, from stocks or bonds held directly by him, or from securities held for him by a custodian resident in the United States, so that his total gross fixed or determinable annual or periodical income from United States sources is in excess of $21,600 and a return of income is not filed by him or on his behalf, the Commissioner will cause a return of income to be made and include therein the fixed or determinable annual or periodical income from all sources within the United States concerning which he has information without allowance for deductions and credits, and will assess the tax and collect it from one or more of the sources of income within the United States. Such nonresident alien shall make or have made a full and accurate return on Form 1040 NB-a of all his fixed or determinable annual or periodical income from sources within the United States. As to the duty of the representative or agent of such alien to file the return

and pay the tax, see paragraph (*b*) of article 217-2, which is hereby made equally applicable in the case of a nonresident alien individual coming within the provisions of this paragraph.

(*b*) *United States business or office.*—Unless a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States or had an office or place of business therein shall file, or cause to be filed, with the collector, a true and accurate return of his total income from sources within the United States, as required by paragraph (*b*) of article 217-2, the tax shall be collected on the basis of the gross income (not the net income) from sources within the United States. Where such a nonresident alien has various sources of income within the United States, so that his total income calls for the assessment of a surtax, and a return of income was not filed by him or on his behalf, the Commissioner will cause a return of income to be made and include therein the income of such nonresident alien from all sources concerning which he has information, without allowance for deductions or credits, and will assess the tax and collect it from one or more of the sources of income of such nonresident alien within the United States.

SEC. 216. *Credits against tax.*—A nonresident alien individual shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 131.

SEC. 217. *Returns.*—(*a*) *Requirement.*—In the case of a nonresident alien individual the return, in lieu of the time prescribed in section 53 (a) (1), shall be made on or before the fifteenth day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then on or before the fifteenth day of June.

(*b*) *Exemption from requirement.*—Subject to such conditions, limitations, and exceptions and under such regulations as may be prescribed by the Commissioner, with the approval of the Secretary, nonresident alien individuals subject to the tax imposed by section 211 (a) may be exempted from the requirement of filing returns of such tax.

ART. 217-1. *Time and place for filing returns of nonresident alien individuals.*—The return in the case of a nonresident alien individual must be made on or before the 15th day of the sixth month following the close of the fiscal year or on or before the 15th day of June, if on the basis of the calendar year. The return must be filed with the collector of internal revenue for the district in which the nonresident alien individual has his principal place of business in the United States, or if he has no principal place of business in the United States, then with the collector of internal revenue at Baltimore, Md. For failure to make and file return within the time prescribed see section 291. For cases in which no return is required see paragraph (*a*) of article 217-2.

ART. 217-2. *Return of income*—(*a*) *No United States business or office*—(1) *General rule.*—If the tax liability of a nonresident alien individual, not engaged in trade or business within the United States and not having any office or place of business therein at any time during the taxable year, is fully satisfied at the source a return of income is not required. A nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year shall make or have made a return on Form 1040NB with respect to that portion of his income received from sources within the United States consisting of interest on so-called tax-free covenant bonds on which a tax of only 2 percent was withheld at the source, and with respect to any other fixed or determinable annual or periodical income upon which the tax was not fully satisfied at the source, including dividends received from a foreign corporation which are treated as income from sources within the United States under section 119 (a) (2) (B), and shall pay the balance of the tax shown to be due.

(2) *Aggregate more than $21,600.*—A nonresident alien individual (other than a resident of Canada) not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year deriving in such year more than $21,600 gross amount of fixed or determinable annual or periodical income from sources within the United States, shall make or have made a full and accurate return on Form 1040 NB-a of all his fixed or determinable annual or periodical income from sources within the United States. Such return need not disclose profits derived from the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian, or profits derived from the sale within the United States of personal property or real property located therein. As to the duty of the representative or agent of such alien to file the return and pay the tax, see paragraph (*b*) of this article, which is hereby made equally applicable in the case of a nonresident alien coming within the provisions of this paragraph.

(*b*) *United States business or office.*—If a nonresident alien individual at any time within the taxable year is engaged in trade or business within the United States or has an office or place of business therein he shall make or have made a full and accurate return on Form 1040B of his income received from all sources within the United States. A return will not be required, however, in the case of such a nonresident alien individual, a resident of Canada or Mexico, whose sole income from sources within the United States consists of compensation for personal services and does not exceed $1,000 during the taxable year.

The responsible representative or agent within the United States of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States or had an office or place of business therein, shall make in behalf of his nonresident alien principal, a return of, and shall pay the tax on, all income from sources within the United States coming within his control as representative or agent. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes. See article 51-2. Any person who collects interest or dividends on deposited securities of such a nonresident alien, executes ownership certificates in connection therewith and sells such securities under special instructions shall not be deemed merely by reason of such acts to be the responsible representative or agent of the nonresident alien. Where upon filing a return of income it appear that such a nonresident alien is not liable for tax, but nevertheless a tax shall have been withheld at the source, in order to obtain a refund on the basis of the showing made by the return there should be attached to it a statement showing accurately the amounts of tax withheld, with the names and post-office addresses of all withholding agents. (See article 143-4.)

SEC. 218. *Payment of tax.*—(*a*) *Time of payment.*—In the case of a nonresident alien individual the total amount of tax imposed by this title shall be paid, in lieu of the time prescribed in section 56 (a), on the fifteenth day of June following the close of the calendar year, or, if the return should be made on the basis of a fiscal year, then on the fifteenth day of the sixth month following the close of the fiscal year.

(*b*) *Withholding at source.*—For withholding at source of tax on income of nonresident aliens, see section 143.

ART. 218-1. *Date on which tax shall be paid by nonresident alien individual.*—In the case of a nonresident alien individual the tax is to be paid on or before the 15th day of June following the close of the calendar year, or, where the return is made on the basis of a fiscal year, on or before the 15th day of the sixth month following the close of the fiscal year. As to payment of the tax in installments, see article 56-1.

SEC. 219. *Partnerships.*—For the purpose of this title, a nonresident alien individual shall be considered as being engaged in a trade or business within the United States if the partnership of which he is a member is so engaged and as having an office or place of business within the United States if the partnership of which he is a member has such an office or place of business.

ART. 219-1. *Partnerships.*—Whether a nonresident alien individual who is a member of a partnership is taxable under the provisions of (A) section 211 (a) or 211 (c) or (B) section 211 (b) may depend on the status of the partnership. A nonresident alien individual who is a member of a partnership which is not engaged in trade or business within the United States and has no office or place of business therein is subject to the provisions of section 211 (a) or 211 (c), as the case may be, depending on whether in the taxable year he derives fixed or determinable annual or periodical income from sources within the United States of more than $21,600, if he is not otherwise engaged in trade or business within the United States and has no office or place of business therein. A nonresident alien individual who is a member of a partnership which at any time within the taxable year is engaged in trade or business within the United States or has an office or place of business therein is considered as being engaged in trade or business within the United States or as having an office or place of business therein and is therefore taxable under section 211 (b). For definition of what the term "partnership" includes see section 901 (a) (3). The test of whether a partnership is engaged in trade or business within the United States, or has an office or place of business therein, is the same as in the case of a nonresident alien individual. (See article 211–7.)

CHAPTER XXVII

Foreign Corporations

Supplement I—Foreign Corporations

SEC. 231. *Tax on foreign corporations.*—(*a*) *Nonresident corporations.*—There shall be levied, collected, and paid for each taxable year, in lieu of the tax imposed by sections 13 and 14, upon the amount received by every foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein, from sources within the United States as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, a tax of 15 per centum of such amount, except that in the case of dividends the rate shall be 10 per centum, and except that in the case of corporations organized under the laws of a contiguous country such rate of 10 per centum with respect to dividends shall be reduced to such rate (not less than 5 per centum) as may be provided by treaty with such country. For inclusion in computation of tax of amount specified in shareholder's consent, see section 28.

(*b*) *Resident corporations.*—A foreign corporation engaged in trade or business within the United States or having an office or place of business therein shall be taxable as provided in section 14 (e) (1).

(*c*) *Gross income.*—In the case of a foreign corporation gross income includes only the gross income from sources within the United States.

(*d*) *Ships under foreign flag.*—The income of a foreign corporation, which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States, shall not be included in gross income and shall be exempt from taxation under this title.

ART. 231–1. *Taxation of foreign corporations.*—For the purposes of this article and articles 231–2, 232–1, 235–1, 235–2, and 236–1, foreign corporations are divided into two classes: (*a*) foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein at any time within the taxable year, referred to in the regulations as nonresident foreign corporations (see article 901–8); and (*b*) foreign corporations which at any time within the taxable year are engaged in trade or business within the United States or have an office or place of business therein, referred to in the regulations as resident foreign corporations (see article 901–8).

(*a*) *Nonresident foreign corporations.*—A nonresident foreign corporation is liable to the tax upon the amount received from sources within the United States, determined under the provisions of section 119, which is fixed or determinable annual or periodical gains, profits, and income. For the purposes of section 231 (a), the term "amount received" means "gross income." Specific items of fixed or determinable annual or periodical income are enumerated in the Act as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, but other fixed or determinable annual or periodical gains, profits, and income are also subject to the tax, as, for instance, royalties. As to the definition of fixed or determinable annual or periodical income see article 143–2. The items of fixed or determinable annual or periodical income from sources within the United States received by a corporation organized under the laws of France, which are exempt from Federal income tax under the provisions of the convention and protocol between the United States and France signed April 27, 1932, and effective January 1, 1936, are described in article 143–3.

The fixed or determinable annual or periodical income from sources within the United States, including royalties, but excluding dividends, of a nonresident foreign corporation is taxable at the rate of 15 percent. Dividends which are treated as income from sources within the United States are taxable at the rate of 10 percent, except that in the case of a nonresident foreign corporation organized under the laws of a contiguous country, such rate of 10 percent shall be reduced to such rate (not less than 5 percent) as may be provided by treaty with such country.

(*b*) *Resident foreign corporations.*—A resident foreign corporation is not taxable at the rate of 15 percent upon the items of fixed or determinable annual or periodical income enumerated in section 231 (a). A resident foreign corporation is liable to a tax of 19 percent upon its special class net income, that is, its net income from sources within the United States (gross income from sources within the United States minus the statutory deductions provided in sections 23 and 232) less the credits allowed against net income by section 26 (a) and (b). (See section 14 (a).)

As used in section 231, section 119, section 143, section 144, and section 211, the phrase "engaged in trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year. Such phrase does not include the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian.

Whether a foreign corporation has an "office or place of business" within the United States depends upon the facts in a particular case. The term "office or place of business," however, implies a place for the regular transaction of business and does not include a place where casual or incidental transactions might be, or are, effected.

ART. 231–2. *Gross income of foreign corporations.*—In the case of a foreign corporation, including a life insurance company not carrying on an insurance business within the United States and holding no reserve funds upon business transacted within the United States (see section 201 (b) (3)), an insurance company other than life or mutual not carrying on an insurance business within the United States (see section 204 (a) (3)) and a mutual insurance company other than life not carrying on an insurance business within the United States (see section 207 (a)), the term "gross income" means gross income from sources within the United States as defined and described in section 119. (See articles 119–1 to 119–14.) The items of gross income from sources without the United States and therefore not taxable to foreign corporations are described in section 119 (c). As to the definition of a foreign corporation see section 901 (a) (2) and (5). As to foreign life insurance companies, see article 201 (b)–2. As to foreign corporations formed or availed of to avoid surtax see article 102–4. As to personal holding companies organized under the laws of foreign countries, see article 406–1. As to foreign personal holding companies, see Chapter XXXIV.

(*a*) *Nonresident foreign corporations.*—A nonresident foreign corporation is taxable under section 231 (a) only on fixed or determinable annual or periodical gross income received from sources within the United States. Its taxable income does not include profits derived from the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian, or profits derived from the sale within the United States of personal property or real property located therein.

(*b*) *Resident foreign corporations.*—The gross income from sources within the United States of a resident foreign corporation is not limited to the items of fixed or determinable annual or periodical income referred to in section 231 (a), but includes every item of gross income which is treated as income from sources within the United States, except those items which are specifically exempt from taxation by statute or treaty or which are not taxable by the Federal Government under the Constitution. (See sections 22 (b), 119, and 231 (d).)

A foreign corporation which effects transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian is not merely by reason of such transactions considered as being engaged in trade or business within the United States which would cause it to be classed as a resident foreign corporation. However, a foreign corporation which at any time within the taxable year is otherwise engaged in trade or business in the United States or has an office or place of business therein, being a resident foreign corporation, is taxable upon all income derived from sources within the United States, including the profits realized from such transactions. A resident foreign corporation is also required to include in its gross income capital gains, gains from hedging transactions, and profits derived from the sale within the United States of personal property, or of real property located therein.

ART. 231-3. *Exclusion of earnings of foreign ships from gross income.*—A resident foreign corporation may exclude from gross income under section 231 (d) so much of its income from sources within the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of a foreign country, to the same extent as provided in article 212-2 with respect to nonresident alien individuals.

A nonresident foreign corporation is not required to include in gross income such income from sources within the United States as is derived from the operation of a ship or ships, whether or not the foreign country under the laws of which such ships are documented meets the equivalent exemption requirements of the statute.

SEC. 232. *Deductions.*—(a) *In general.*—In the case of a foreign corporation the deductions shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 119, under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

(b) *Charitable, and so forth, contributions.*—The so-called "charitable contribution" deduction allowed by section 23 (q) shall be allowed whether or not connected with income from sources within the United States.

ART. 232-1. *Deductions allowed foreign corporations*—(a) *Nonresident foreign corporations.*—A nonresident foreign corporation is not allowed any deductions from gross income from sources within the United States, the tax being imposed upon the amount of gross income received. (See article 231-1.)

(b) *Resident foreign corporations.*—A resident foreign corporation is allowed the same deductions from its gross income arising from sources within the United States as are allowed a domestic corporation under section 23 to the extent that such deductions are connected with such gross income, except that the so-called charitable contribution deduction allowed by section 23 (q) is allowed whether or not connected with income from sources within the United States. The proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 119. As to foreign life insurance companies, see article 201 (b)-2. As to foreign corporations formed or availed of to avoid surtax, see article 102-4. As to personal holding companies organized under the laws of foreign countries, see article 406-1. As to foreign personal holding companies, see Chapter XXXIV.

SEC. 233. *Allowance of deductions and credits.*—A foreign corporation shall receive the benefit of the deductions and credits allowed to it in this title only by filing or causing to be filed with the collector a true and accurate return of its total income received from all sources in the United States, in the manner prescribed in this title; including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits.

ART. 233-1. *Allowance of deductions and credits.*—The benefit of the deductions and credits allowed a resident foreign corporation can be had only by filing or causing to be filed with the collector a true and accurate return of its total income received from sources within the United States. Only items of interest and dividends included in gross income may be credited under section 26 (a) and (b). Inasmuch as a nonresident foreign corporation is taxable under section 231 (a) only upon fixed or determinable annual or periodical gross income received from sources within the United States, such foreign corporation may not receive the benefit of the deductions and credits by filing a return of income.

SEC. 234. *Credits against tax.*—Foreign corporations shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 131.

SEC. 235. *Returns.*—(a) *Time of filing.*—In the case of a foreign corporation not having any office or place of business in the United States the return, in lieu of the time prescribed in section 53 (a) (1), shall be made on or before the fifteenth day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of the calendar year then on or before the fifteenth day of June. If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return shall be made by the agent.

(b) *Exemption from requirement.*—Subject to such conditions, limitations, and exceptions and under such regulations as may be prescribed by the Commissioner, with the approval of the Secretary, corporations subject to the tax imposed by section 231 (a) may be exempted from the requirement of filing returns of such tax.

ART. 235-1. *Time and place for filing returns of foreign corporations*—(a) *Nonresident foreign corporations.*—The return in the case of a nonresident foreign corporation must be made on or before the 15th day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of a calendar year then on or before the 15th day of June. If a nonresident foreign corporation has an agent in the United States, the return shall be made by the agent. The return must be filed with the collector of internal revenue, Baltimore, Md. (See section 53 (b) (2).) For failure to make and file a return within the time prescribed, see section 291. For cases in which no return is required see paragraph (a) of article 235-2.

(b) *Resident foreign corporations.*—The return in the case of a resident foreign corporation, in lieu of the time prescribed in section 235, shall be made on or before the 15th day of the third month following the close of the fiscal year, or on or before the 15th day of March if on the basis of the calendar year. (See section 53 (a) (1).) The return must be filed with the collector of internal revenue for the district in which the resident foreign corporation has its principal place of business or principal office or agency in the United States. (See section 53 (b) (2).) For failure to make and file a return within the time prescribed see section 291.

ART. 235-2. *Return of income*—(a) *Nonresident foreign corporations.*—If the tax liability of a nonresident foreign corporation is fully satisfied at the source a return of income is not required. A nonresident foreign corporation shall make or have made a return on Form 1120NB with respect to that portion of its income received from sources within the United States consisting of interest on so-called tax-free covenant bonds on which a tax of only 2 percent was withheld at the source, and with respect to any other fixed or determinable annual or periodical income upon which the tax was not fully satisfied at the source, including dividends received from a foreign corporation which are treated as income from sources within the United States under section 119 (a) (2) (B), and shall pay the balance of the tax shown to be due.

(b) *Resident foreign corporations.*—If a foreign corporation at any time within the taxable year is a resident corporation it shall make a full and accurate return on Form 1120 of its income received from sources within the United States.

SEC. 236. *Payment of tax.*—(a) *Time of payment.*—In the case of a foreign corporation not having any office or place of business in the United States the total amount of tax imposed by this title shall be paid, in lieu of the time prescribed in section 56 (a), on the fifteenth day of June following the close of the calendar year, or, if the return should be made on the basis of a fiscal year, then on the fifteenth day of the sixth month following the close of the fiscal year.

(b) *Withholding at source.*—For withholding at source of tax on income of foreign corporations, see section 144.

ART. 236-1. *Dates on which tax shall be paid by foreign corporations*—(a) *Nonresident foreign corporations.*—In the case of a nonresident foreign corporation the total amount of tax imposed by section 231 (a) shall be paid on the 15th day of June following the close of the calendar year, or if the return should be made on the basis of a fiscal year, then on the 15th day of the sixth month following the close of the fiscal year. As to payment of the tax in installments, see article 56-1.

(b) *Resident foreign corporations.*—In the case of a resident foreign corporation the total amount of tax provided by sections 231 (b) and 14 (e) (1) shall be paid, in lieu of the time prescribed in section 236 (a), on the 15th day of March following the close of the calendar year, or if the return is made on the basis of a fiscal year, then on the 15th day of the third month following the close of the fiscal year. As to payment of the tax in installments see article 56-1.

SEC. 237. *Foreign insurance companies.*—For special provisions relating to foreign insurance companies, see Supplement G.

SEC. 238. *Affiliation.*—A foreign corporation shall not be deemed to be affiliated with any other corporation within the meaning of section 141.

CHAPTER XXVIII

Income From Sources Within Possessions of United States

Supplement J—Possessions of the United States

SEC. 251. *Income from sources within possessions of United States.*—(a) *General rule.*—In the case of citizens of the United States or domestic corporations, satisfying the following conditions, gross income means only gross income from sources within the United States—

(1) If 80 per centum or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section), for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) If, in the case of such corporation, 50 per centum or more of its gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(3) If, in case of such citizen, 50 per centum or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) *Amounts received in United States.*—Notwithstanding the provisions of subsection (a) there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) *Tax in case of corporations.*—A domestic corporation entitled to the benefits of this section shall be taxable as provided in section 14 (d). For inclusion in computation of tax of amount specified in shareholder's consent, see section 28.

(d) *Definition.*—As used in this section the term "possession of the United States" does not include the Virgin Islands of the United States.

(e) *Deductions.*—(1) Citizens of the United States entitled to the benefits of this section shall have the same deductions as are allowed by Supplement H in the case of a nonresident alien individual engaged in trade or business within the United States or having an office or place of business therein.

(2) Domestic corporations entitled to the benefits of this section shall have the same deductions as are allowed by Supplement I in the case of a foreign corporation engaged in trade or business within the United States or having an office or place of business therein.

(f) *Credits against net income.*—A citizen of the United States entitled to the benefits of this section shall be allowed a personal exemption of only $1,000 and shall not be allowed the credit for dependents provided in section 25 (b) (2).

(g) *Allowance of deductions and credits.*—Citizens of the United States and domestic corporations entitled to the benefits of this section shall receive the benefit of the deductions and credits allowed to them in this title only by filing or causing to be filed with the collector a true and accurate return of their total income received from all sources in the United States, in the manner prescribed in this title; including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits.

(h) *Credits against tax.*—Persons entitled to the benefits of this section shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 131.

(i) *Affiliation.*—A corporation entitled to the benefits of this section shall not be deemed to be affiliated with any other corporation within the meaning of section 141.

ART. 251-1. *Citizens of the United States and domestic corporations deriving income from sources within a possession of the United States.*—In the case of a citizen of the United States or a domestic corporation satisfying the following conditions, gross income means only gross income from sources within the United States—

(1) If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 251) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States, and

(2) If 50 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 251) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States. In the case of a citizen, the trade or business may be conducted on his own account or as an employee or agent of another. The salary or other compensation paid by the United States to the members of its civil, military, or naval personnel for services rendered within a possession of the United States represents income derived from the active conduct of a trade or business within a possession of the United States. Dividends received by a citizen from a corporation whose income was derived from the active conduct of a business within a possession of the United States, although such citizen was actively engaged in the management of such corporation, does not represent income derived from the active conduct of a trade or business within the possession of the United States, either on the taxpayer's own account or as an employee or agent of another.

A citizen of the United States who on account of the nature and amount of his income cannot meet the 80 percent and the 50 percent requirements of the statute, but who receives earned income from sources within a possession of the United States is not deprived of the benefits of the provisions of section 116 (a), provided he is away from the United States for more than six months of the taxable year, and does not receive his earned income from the United States or any agency thereof. In such a case none of the provisions of section 251 is applicable in determining the citizen's tax liability. For what constitutes earned income see section 25 (a) (4).

For a determination of the income from sources within the United States, see section 119. A citizen entitled to the benefits of section 251 is required to file with his individual return Form 1040 or 1040 A, the schedule on Form 1040 E. If a citizen entitled to the benefits of section 251 has no income from sources within the United States or does not receive within the United States any income whether derived from sources within or without the United States, he is not required to file a return or the schedule on Form 1040 E.

Example: On July 1, 1938, A, who is a citizen of the United States, went to Puerto Rico and established a business there which he actively conducted during the remainder of that year. His gross income from the business during such period was $20,000. In addition, he made a profit of $12,000 from the sale during the latter part of 1938 of some Puerto Rican real estate not connected with his trade or business. In the first six months of 1938 he also derived $8,000 gross income from rental property located in the United States. He derived a like amount of gross income from such property during the last six months of 1938. Inasmuch as for the applicable part (July 1, 1938, to December 31, 1938) of the 3-year period immediately preceding the close of the taxable year (the calendar year 1938), 80 percent of A's gross income ($32,000, or 80 percent of $40,000) was derived from sources within a possession of the

United States and as 50 percent or more of his gross income ($20,000, or 50 percent of $40,000) for such part of the 3-year period was derived from the active conduct of a trade or business within a possession of the United States, he is required to report in gross income in his return for 1938 only the gross income derived by him from sources within the United States ($16,000 from the rental property located in the United States).

ART. 251-2. *Income received within the United States.*—Notwithstanding the provisions of section 251 (a), there shall be included in the gross income of citizens and domestic corporations therein specified all amounts, whether derived from sources within or without the United States, which are received by such citizens or corporations within the United States. From the amounts so included in gross income there shall be deducted only the expenses properly apportioned or allocated thereto. For instance, if in the example given in article 251-1, the taxpayer during the latter part of 1938 returned to the United States for a few weeks and while there received the proceeds resulting from the sale of the Puerto Rican real estate, the profits derived from such transaction should be reported in gross income. Such receipt in the United States, however, would not deprive the taxpayer of the benefits of section 251 with respect to other items of gross income excluded by that section.

ART. 251-3. *Tax in case of corporations.*—A domestic corporation entitled to the benefits of section 251 is taxable at the rate of 16½ percent as provided in sections 251 (c) and 14 (d) and is not subject to the tax imposed by section 13.

ART. 251-4. *Definition.*—The term "United States" as used herein includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia. The term "possession of the United States," as used in sections 251 and 252 and article 251-1, this article, and article 252-1, includes Puerto Rico, the Philippine Islands, the Panama Canal Zone, Guam, American Samoa, Wake, Palmyra, and the Midway Islands; it does not include the Virgin Islands. The Philippine Islands come within the classification of "possessions of the United States" for Federal income tax purposes, notwithstanding the establishment of the Commonwealth of the Philippines under the Act of March 24, 1934 (48 Stat., 456).

ART. 251-5. *Deductions allowed citizens and domestic corporations entitled to the benefits of section 251.*—In the case of a citizen entitled to the benefits of section 251, the deductions allowed by section 23 for business expenses, interest, taxes, losses in trade, bad debts, depreciation, and depletion are allowed only if and to the extent that they are connected with income from sources within the United States. The provisions of article 213-1 relating to the allowance to nonresident alien individuals who at any time within the taxable year were engaged in trade or business within the United States or had an office or place of business therein, of the deductions provided in paragraphs (2) and (3) of section 23 (e) for losses not connected with the trade or business are applicable in the case of citizens entitled to the benefits of section 251. The provisions of that article pertaining to the allowance to such nonresident alien individuals of deductions for contributions provided in section 23 (o) are also applicable in the case of such citizens. Corporations entitled to the benefits of section 251 are allowed the same deductions from their gross income arising from sources within the United States as are allowed to domestic corporations to the extent that such deductions are connected with such gross income, except that the so-called charitable contribution deduction allowed by section 23 (q) is allowed whether or not connected with income from sources within the United States. The proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 119.

ART. 251-6. *Allowance of deductions and credits to citizens and domestic corporations entitled to the benefits of section 251.*—Unless a citizen of the United States or a domestic corporation entitled to the benefits of section 251 shall file, or cause to be filed with the collector, a true and accurate return of total income from sources within the United States, the tax shall be collected on the basis of the gross income (not the net income) from sources within the United States. Where such a citizen or corporation has various sources of income within the United States so that the total income calls for the assessment of a tax, and a return of income was not filed by or on behalf of the citizens or corporation, the Commissioner will cause a return of income to be made and include therein the income of such citizen or corporation from all sources concerning which he has information, and will assess the tax and collect it from one or more of the sources of income of such citizen or corporation within the United States without allowance for deductions or credits.

SEC. 252. *Citizens of possessions of United States.*

(a) Any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under this title only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources.

(b) Nothing in this section shall be construed to alter or amend the provisions of the Act entitled "An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes", approved July 12, 1921, relating to the imposition of income taxes in the Virgin Islands of the United States.

ART. 252-1. *Status of citizens of United States possession.*—A citizen of a possession of the United States (except the Virgin Islands), who is not otherwise a citizen or resident of the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, is treated for the purpose of the tax as if he were a nonresident alien individual. (See sections 211-219.) For Federal income tax purposes a citizen of a possession of the United States who is not otherwise a citizen of the United States, is a citizen of a possession of the United States who has not become a citizen of the United States by naturalization. The fixed or determinable annual or periodical income from sources within the United States of a citizen of a possession of the United States who is treated as if he were a nonresident alien individual is subject to withholding. (See section 143.)

For the purpose of this article citizens of the possessions of the United States who are not otherwise citizens of the United States are divided into two classes: (1) citizens of possessions of the United States who at any time within the taxable year are not engaged in trade or business within the United States and have no office or place of business therein and (2) citizens of possessions of the United States who at any time within the taxable year are engaged in trade or business within the United States or have an office or place of business therein. The provisions of articles 211-7 to 219-1, inclusive, applicable to nonresident alien individuals not engaged in trade or business within the United States and not having an office or place of business therein are applicable to the citizens of possessions falling within the first class, while the provisions of such articles applicable to nonresident alien individuals who at any time within the taxable year are engaged in trade or business within the United States or have an office or place of business therein are applicable to citizens of possessions falling within the second class.

The Act referred to in section 252 (b) provides that income tax laws then or thereafter in force in the United States shall apply to the Virgin Islands, but that the taxes shall be paid into the treasury of the Virgin Islands. Accordingly, persons are taxed there under the provisions of the Revenue Act of 1938.

CHAPTER XXIX

China Trade Act Corporations

Supplement K—China Trade Act Corporations

SEC. 261. *Taxation in general.*—A corporation organized under the China Trade Act, 1922, shall be taxable as provided in section 14 (d). For inclusion in computation of tax of amount specified in shareholder's consent, see section 23.

SEC. 262. *Credit against net income.*—(a) *Allowance of credit.*—For the purpose only of the taxes imposed by sections 14 and 602 of this Act and section 106 of the Revenue Act of 1935 there shall be allowed, in the case of a corporation organized under the China Trade Act, 1922, in addition to the credits against net income otherwise allowed such corporation, a credit against the net income of an amount equal to the proportion of the net income derived from sources within China (determined in a similar manner to that provided in section 119) which the par value of the shares of stock of the corporation owned on the last day of the taxable year by (1) persons resident in China, the United States, or possessions of the United States, and (2) individual citizens of the United States or China wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on such date: *Provided*, That in no case shall the diminution, by reason of such credit, of the tax imposed by such section 14 (computed without regard to this section) exceed the amount of the special dividend certified under subsection (b) of this section; and in no case shall the diminution, by reason of such credit, of the tax imposed by such section 106 or 602 (computed without regard to this section) exceed the amount by which such special dividend exceeds the diminution permitted by this section in the tax imposed by such section 14.

(b) *Special dividend.*—Such credit shall not be allowed unless the Secretary of Commerce has certified to the Commissioner—

(1) The amount which, during the year ending on the date fixed by law for filing the return, the corporation has distributed as a special dividend to or for the benefit of such persons as on the last day of the taxable year were resident in China, the United States, or possessions of the United States, or were individual citizens of the United States or China, and owned shares of stock of the corporation;

(2) That such special dividend was in addition to all other amounts, payable or to be payable to such persons or for their benefit, by reason of their interest in the corporation; and

(3) That such distribution has been made to or for the benefit of such persons in proportion to the par value of the shares of stock of the corporation owned by each; except that if the corporation has more than one class of stock, the certificates shall contain a statement that the articles of incorporation provide a method for the apportionment of such special dividend among such persons, and that the amount certified has been distributed in accordance with the method so provided.

(c) *Ownership of stock.*—For the purposes of this section shares of stock of a corporation shall be considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

(d) *Definition of China.*—As used in this section the term "China" shall have the same meaning as when used in the China Trade Act, 1922.

SEC. 263. *Credits against the tax.*—A corporation organized under the China Trade Act, 1922, shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 131.

SEC. 264. *Affiliation.*—A corporation organized under the China Trade Act, 1922, shall not be deemed to be affiliated with any other corporation within the meaning of section 141.

SEC. 265. *Income of shareholders.*—For exclusion of dividends from gross income, see section 116.

ART. 262–1. *Income of China Trade Act corporations.*—The items of gross income to be included in the return of a corporation organized under the China Trade Act and the deductions allowable are the same as in the case of other domestic corporations.

ART. 262–2. *Credits allowed China Trade Act corporations.*—In addition to the credits allowed under section 26 (a) and (b), a China Trade Act corporation is, under certain conditions, allowed an additional credit for the purpose of computing the taxes imposed by sections 14 (d) and 602 of the Revenue Act of 1938 and section 106 of the Revenue Act of 1935. This credit is an amount equal to the proportion of the net income derived from sources within China (determined in a similar manner to that provided in section 119) which the par value of the shares of stock of the corporation, owned on the last day of the taxable year by (1) persons resident in China, the United States, or possessions of the United States, and (2) individual citizens of the United States or China wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on that date. The decrease in the tax imposed by section 14 (d) by reason of such credit must not, however, exceed the amount of the special dividend referred to in section 262 (b), and is not allowable unless the special dividend has been certified to the Commissioner by the Secretary of Commerce. The decrease in the tax imposed by section 602 of the Revenue Act of 1938 or section 106 of the Revenue Act of 1935 by reason of such credit must not exceed the amount by which such special dividend exceeds the decrease permitted by section 262 in the tax imposed by section 14 (d). A China Trade Act corporation is not entitled to the credit for taxes paid to foreign countries and possessions of the United States allowed to domestic corporations under the provisions of section 131.

The application of this article may be illustrated by the following example:

Example: The A Company, a China Trade Act corporation, has a net income for the calendar year 1938 (before deducting excess-profits tax) of $200,000 and receives no dividends from domestic corporations. All of its stock on December 31, 1938, is owned on that date by persons resident in China, the United States, or possessions of the United States, or individual citizens of the United States or China. The adjusted declared value of the capital stock of the corporation shown on its capital stock tax return for the capital stock tax year ended June 30, 1938, is $1,500,000. It distributes a special dividend amounting to $36,000 on February 15, 1939, which is certified by the Secretary of Commerce as provided in section 262 (b).

For the purpose of the tax imposed by section 14 (d) it is necessary in this example to make two computations, first, without allowing the special credit against net income on account of income derived from sources within China, and, second, allowing such credit. The computations are as follows:

First Computation

Without Allowing the Special Credit Against Net Income

Net income subject to tax	$200,000
Special class net income	200,000
Tax as 16½ percent	33,000
Total normal tax	33,000

Second Computation

Allowing Special Credit Against Net Income

Net income	$200,000
Since the total net income is derived from sources within China and since the par value of the shares of stock of the corporation owned on the last day of the taxable year by (1) persons resident in China, the United States, or possessions of the United States, and (2) individual citizens of the United States or China wherever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of the net income from sources within China is deductible as a special credit against net income.	
Special credit against net income	$200,000
Amount of income subject to tax under section 14 (d)	None

Since the special dividend ($36,000) exceeds the diminution of the tax ($33,000) on account of the allowance of the special credit against net income, the entire amount of the special credit is allowable and the corporation has no income tax liability for 1938.

For the purpose of the excess-profits tax it is also necessary to make two computations, first, without allowing the special credit against net income, and, second, allowing such credit. The computations are as follows:

First computation

Without allowing the special credit against net income

Net income	$200,000
Less: 10 percent of the value declared in the capital stock tax return for the capital stock tax year ended June 30, 1938 (10 percent of $1,500,000)	150,000
Net income subject to excess-profits tax	50,000
Less: Amount taxable at 6 percent, portion of net income in excess of 10 percent and not in excess of 15 percent of the adjusted declared value of the capital stock ($200,000 minus $150,000)	50,000
Amount taxable at 12 percent	None
Excess-profits tax at 6 percent (6 percent of $50,000)	3,000

Second computation

Allowing special credit against net income

Net income	$200,000
Since the total net income is derived from sources within China and since the par value of the shares of stock of the corporation owned on the last day of the taxable year by (1) persons resident in China, the United States, or possessions of the United States, and (2) individual citizens of the United States or China wherever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of the net income from sources within China is deductible from net income	200,000
Amount of income subject to excess-profits tax	None

Since the diminution of the excess-profits tax ($3,000) on account of the special credit against net income does not exceed the amount by which the special dividend ($36,000) exceeds the diminution of the income tax ($33,000) on account of such credit, the entire amount of the special credit ($200,000) is allowable and the corporation has no excess-profits tax liability for 1938.

ART. 262-3. *Meaning of terms used in connection with China Trade Act corporations.*—A China Trade Act corporation is one organized under the provisions of the China Trade Act, 1922.

The term "China" means (1) China, including Manchuria, Tibet, Mongolia, and any territory leased by China to any foreign government, (2) the Crown Colony of Hongkong, and (3) the Province of Macao.

The term "special dividend" means the amount which during the year ending on March 15 succeeding the close of the corporation's taxable year is distributed as a special dividend to or for the benefit of such persons as on the last day of the taxable year were resident in China, the United States, or possessions of the United States, or were individual citizens of the United States or China, and owned shares of stock of the corporation. Such special dividend does not include any other amounts payable or to be payable to such persons or for their benefit by reason of their interest in the corporation and must be made in proportion to the par value of the shares of stock of the corporation owned by each.

For the purposes of section 262 the shares of stock of a China Trade Act corporation are considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

"Net income derived from sources within China" is the sum of the net income from sources wholly within China and that portion of the net income from sources partly within and partly without China which may be allocated to sources within China. The method of computing this income is similar to that described in section 119.

ART. 262-4. *Withholding by a China Trade Act corporation.*—Dividends distributed by a corporation organized under the China Trade Act, 1922, which are treated as income from sources within the United States under the provisions of section 119 of the Act are subject to withholding at the rate of 10 percent when paid to persons (other than residents of China) who are (1) nonresident aliens, (2) nonresident partnerships composed in whole or in part of nonresident aliens, or (3) nonresident foreign corporations. The 10 percent rate of withholding specified in this article with respect to dividends shall be reduced in the case of shareholders who are (*a*) nonresident aliens residents of a contiguous country or (*b*) nonresident foreign corporations organized under the laws of a contiguous country, to such rate (not less than 5 percent), as may be provided by treaty with such country. As to reduction in rate of withholding (*a*) in the case of nonresident alien individuals, residents of Canada, see article 143-1; (*b*) in the case of nonresident foreign corporations organized under the laws of Canada, see article 144-1.

CHAPTER XXX

Assessment and Collection of Deficiencies

Supplement L—Assessment and Collection of Deficiencies

SEC. 271. *Definition of deficiency.*—As used in this title in respect of a tax imposed by this title "deficiency" means—

(a) The amount by which the tax imposed by this title exceeds the amount shown as the tax by the taxpayer upon his return; but the amount so shown on the return shall first be increased by the amounts previously assessed (or collected without assessment) as a deficiency, and decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax; or

(b) If no amount is shown as the tax by the taxpayer upon his return, or if no return is made by the taxpayer, then the amount by which the tax exceeds the amounts previously assessed (or collected without assessment) as a deficiency; but such amounts previously assessed, or collected without assessment, shall first be decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax.

ART. 271-1. *Deficiency defined.*—Section 271 by its definition of the word "deficiency" provides a term which will apply to any amount of tax determined to be due in respect of any taxable year beginning after December 31, 1937, in excess of the amount of tax reported by the taxpayer for such year; or in excess of the amount reported by the taxpayer as adjusted by way of prior assessments, abatements, credits, refunds, or collections without assessment. In defining the term "deficiency" section 271 recognizes two classes of cases—one, where the taxpayer makes a return showing some tax liability; the other, where the taxpayer makes a return showing no tax liability, or where the taxpayer fails to make a return. Additional tax shown on an "amended return," so called, is a deficiency within the meaning of the Act.

When a case is considered for the first time, the deficiency is the excess of the amount determined to be the correct amount of the tax over the amount shown as the tax by the taxpayer on his return, or, if it is a case where no tax was reported by the taxpayer, the deficiency is the amount determined to be the correct amount of the tax. Subsequent information sometimes discloses that the amount previously determined to be the correct amount of the tax is less than the correct amount, and that a redetermination of the tax is necessary. In such a case the deficiency on redetermination is the excess of the amount determined to be the correct amount of the tax over the sum of the amount of tax reported by the taxpayer and the deficiency assessed in connection with the previous determination. If it is a case where no tax was reported by the taxpayer, the deficiency is the excess of the amount determined to be the correct amount of the tax over the amount of the deficiency disclosed by the previous determination. If the previous determination resulted in a credit or refund to the taxpayer, the deficiency upon the second determination is the excess of the amount determined to be the correct amount of the tax over the amount of tax reported by the taxpayer decreased by the amount of the credit or refund.

SEC. 272. *Procedure in general.*—(*a*) *Petition to Board of Tax Appeals.*—If in the case of any taxpayer, the Commissioner determines that there is a deficiency in respect of the tax imposed by this title, the Commissioner is authorized to send notice of such deficiency to the taxpayer by registered mail. Within ninety days after such notice is mailed (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day), the taxpayer may file a petition with the Board of Tax Appeals for a redetermination of the deficiency. No assessment of a deficiency in respect of the tax imposed by this title and no distraint or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such ninety-day period, nor, if a petition has been filed with the Board, until the decision of the Board has become final. Notwithstanding the provisions of section 3224 of the Revised Statutes the making of such assessment or the beginning of such proceeding or distraint during the time such prohibition is in force may be enjoined by a proceeding in the proper court. In the case of a joint return filed by husband and wife such notice of deficiency may be a single joint notice, except that if the Commissioner has been notified by either spouse that separate residences have been established, then, in lieu of the single joint notice, duplicate originals of the joint notice must be sent by registered mail to each spouse at his last known address.

For exceptions to the restrictions imposed by this subsection, see—

(1) Subsection (d) of this section, relating to waivers by the taxpayer;

(2) Subsection (f) of this section, relating to notifications of mathematical errors appearing upon the face of the return;

(3) Section 273, relating to jeopardy assessments;
(4) Section 274, relating to bankruptcy and receiverships; and
(5) Section 1001 of the Revenue Act of 1926, as amended, relating to assessment or collection of the amount of the deficiency determined by the Board pending court review.

(b) *Collection of Deficiency found by Board.*—If the taxpayer files a petition with the Board, the entire amount redetermined as the deficiency by the decision of the Board which has become final shall be assessed and shall be paid upon notice and demand from the collector. No part of the amount determined as a deficiency by the Commissioner but disallowed as such by the decision of the Board which has become final shall be assessed or be collected by distraint or by proceeding in court with or without assessment.

(c) *Failure to file petition.*—If the taxpayer does not file a petition with the Board within the time prescribed in subsection (a) of this section, the deficiency, notice of which has been mailed to the taxpayer, shall be assessed, and shall be paid upon notice and demand from the collector.

(d) *Waiver of restrictions.*—The taxpayer shall at any time have the right, by a signed notice in writing filed with the Commissioner, to waive the restrictions provided in subsection (a) of this section on the assessment and collection of the whole or any part of the deficiency.

(e) *Increase of deficiency after notice mailed.*—The Board shall have jurisdiction to redetermine the correct amount of the deficiency even if the amount so redetermined is greater than the amount of the deficiency, notice of which has been mailed to the taxpayer, and to determine whether any penalty, additional amount or addition to the tax should be assessed—if claim therefor is asserted by the Commissioner at or before the hearing or a rehearing.

(f) *Further deficiency letters restricted.*—If the Commissioner has mailed to the taxpayer notice of a deficiency as provided in subsection (a) of this section, and the taxpayer files a petition with the Board within the time prescribed in such subsection, the Commissioner shall have no right to determine any additional deficiency in respect of the same taxable year, except in the case of fraud, and except as provided in subsection (e) of this section, relating to assertion of greater deficiencies before the Board, or in section 273 (c), relating to the making of jeopardy assessments. If the taxpayer is notified that, on account of a mathematical error appearing upon the face of the return, an amount of tax in excess of that shown upon the return is due, and that an assessment of the tax has been or will be made on the basis of what would have been the correct amount of tax but for the mathematical error, such notice shall not be considered (for the purposes of this subsection, or of subsection (a) of this section, prohibiting assessment and collection until notice of deficiency has been mailed, or of section 322 (c), prohibiting credits or refunds after petition to the Board of Tax Appeals) as a notice of a deficiency, and the taxpayer shall have no right to file a petition with the Board based on such notice, nor shall such assessment or collection be prohibited by the provisions of subsection (a) of this section.

(g) *Jurisdiction over other taxable years.*—The Board in redetermining a deficiency in respect of any taxable year shall consider such facts with relation to the taxes for other taxable years as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid.

(h) *Final decisions of Board.*—For the purposes of this title the date on which a decision of the Board becomes final shall be determined according to the provisions of section 1005 of the Revenue Act of 1926.

(i) *Prorating of deficiency to installments.*—If the taxpayer has elected to pay the tax in installments and a deficiency has been assessed, the deficiency shall be prorated to the four installments. Except as provided in section 273 (relating to jeopardy assessments), that part of the deficiency so prorated to any installment the date for payment of which has not arrived, shall be collected at the same time as and as part of such installment. That part of the deficiency so prorated to any installment the date for payment of which has arrived, shall be paid upon notice and demand from the collector.

(j) *Extension of time for payment of deficiencies.*—Where it is shown to the satisfaction of the Commissioner that the payment of a deficiency upon the date prescribe for the payment thereof will result in undue hardship to the taxpayer the Commissioner, under regulations prescribed by the Commissioner, with the approval of the Secretary, may grant an extension for the payment of such deficiency for a period not in excess of eighteen months, and, in exceptional cases, for a further period not in excess of twelve months. If an extension is granted, the Commissioner may require the taxpayer to furnish a bond in such amount, not exceeding double the amount of the deficiency, and with such sureties, as the Commissioner deems necessary, conditioned upon the payment of the deficiency in accordance with the terms of the extension. No extension shall be granted if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

(k) *Address for notice of deficiency.*—In the absence of notice to the Commissioner under section 312 (a) of the existence of a fiduciary relationship, notice of a deficiency in respect of a tax imposed by this title, if mailed to the taxpayer at his last known address, shall be sufficient for the purposes of this title even if such taxpayer is deceased, or is under a legal disability, or, in the case of a corporation, has terminated its existence.

ART. 272-1. *Assessment of a deficiency.*—If the Commissioner determines that there is a deficiency in respect of the income tax imposed by Title I (see sections 57 and 271), the Commissioner is authorized to notify the taxpayer of the deficiency by registered mail. If a joint return has been filed by husband and wife the Commissioner may, unless he has been notified by either spouse that a separate residence has been established, send either a joint or separate notice of deficiency. If, however, the Commissioner has been so notified, a separate notice of deficiency, that is, a duplicate original of the joint notice, must be sent by registered mail to each spouse at his or her last known address. The notice to the Commissioner provided for in the first paragraph of section 272 (a), relating to separate residences, should be addressed to the Commissioner of Internal Revenue, Washington, D. C., for the attention of the Income Tax Unit, Records Division. Within 90 days after notice of the deficiency is mailed, as provided in section 272 (a), a petition may be filed with the Board of Tax Appeals for a redetermination of the deficiency. In determining such 90-day period, Sunday or a legal holidy in the District of Columbia is not to be counted as the ninetieth day. Except as stated in paragraphs (1), (2), (3), (4), and (5) of this article, no assessment of a deficiency in respect of a tax imposed by Title I shall be made until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day period, nor, if a petition has been filed with the Board, until the decision of the Board has become final. As to the date on which a decision of the Board becomes final, see section 1005 of the Revenue Act of 1926 (paragraph 16 of the Appendix to these regulations).

(1) If a taxpayer is notified of an additional amount of tax due on account of a mathematical error appearing upon the face of the return, such notice is not to be considered as a notice of a deficiency, and the taxpayer has no right to file a petition with the Board upon the basis of such notice, nor is the assessment of such additional tax prohibited by the provisions of section 272 (a).

(2) If the Commissioner believes that the assessment or collection of a deficiency will be jeopardized by delay, such deficiency shall be assessed immediately, as provided in section 273. (See article 273-1.)

(3) Upon the adjudication of bankruptcy of any taxpayer or the appointment of a receiver for any taxpayer in any receivership proceeding before any court of the United States or of any State or Territory or of the District of Columbia, any deficiency determined by the Commissioner in respect of the tax shall be assessed immediately, irrespective of the provisions of section 272 (a), if such deficiency has not been assessed in accordance with law prior to the adjudication of bankruptcy or the appointment of a receiver. (See sections 274 and 298 and articles 274-1 and 274-2.)

(4) (a) If the Board renders a decision and determines that there is a deficiency, and, if the taxpayer duly files a petition for review of the decision by a circuit court of appeals (or the United States Court of Appeals for the District of Columbia), the filing of the petition will not operate as a stay of the assessment of any portion of the deficiency determined by the Board unless he has filed a bond with the Board as provided in section 1001 (c) of the Revenue Act of 1926, as amended (paragraph 13 of the Appendix to these regulations). If in such a case the necessary bond has not been filed by the taxpayer on or before the time his petition for review is filed, the amount determined by the Board as the deficiency will be assessed immediately after the filing of such petition.

(b) If the Commissioner files a petition for review and (1) if the taxpayer has not filed a petition for review within three months after the decision of the Board is rendered, or (2) if such petition has been filed by the taxpayer, but the necessary bond referred to in section 1001 (c) of the Revenue Act of 1926, as amended, has not been filed with the Board on or before the time his petition for review is filed, the amount determined by the Board as the deficiency will be assessed in the case of (1), immediately after the expiration of the 3-month period, and in the case of (2), immediately after the filing of the petition for review by the taxpayer.

(5) The taxpayer may at any time by a signed notice in writing filed with the Commissioner waive the restrictions on the assessment of the whole or any part of the deficiency. The notice must in all cases be filed with the Commissioner. The filing of such notice with the Board does not constitute filing with the Commissioner within the meaning of the Act. After such waiver has been acted upon by the Commissioner and the assessment has been made in accordance with its terms, the waiver cannot be withdrawn.

If a petition is filed with the Board, the taxpayer should notify the Commissioner that the petition has been filed, in order to prevent an assessment by the Commissioner of the amount determined to be the deficiency. If no petition is filed with the Board within the period prescribed, the Commissioner shall assess the amount determined by him as the deficiency and of which he has notified the taxpayer by registered mail. In such case the Commissioner will not be precluded from determining a further deficiency and notifying the taxpayer thereof by registered mail. Where a petition is filed with the Board, the entire amount redetermined as the deficiency by the decision of the Board which has become final shall be assessed by the Commissioner. If the Commissioner mails to the taxpayer notice of a deficiency, and the taxpayer files a petition with the Board within the prescribed period, the Commissioner is barred from determining any additional deficiency for the same taxable year except in the case of fraud and except as provided in section 272 (e) relating to the assertion of greater deficiencies before the Board or in section 273 relating to jeopardy assessments.

ART. 272-2. *Collection of a deficiency.*—Where a deficiency as redetermined by a decision of the Board which has become final is assessed, or where the taxpayer has not filed a petition and the deficiency as determined by the Commissioner has been assessed, the amount so assessed shall be paid upon notice and demand from the collector. As to cases coming within the provisions of paragraphs (2), (3), and (4) of article 272-1, see sections 273 (i) and 298 of the Revenue Act of 1938 and 1001 (c) of the Revenue Act of 1926, as amended (paragraph 13 of the Appendix to these regulations). As to interest on deficiencies, see section 292.

ART. 272-3. *Extension of time for payment of a deficiency.*—If it is shown to the satisfaction of the Commissioner that the payment of a deficiency upon the date or dates prescribed for the payment thereof will result in undue hardship to the taxpayer, the Commissioner may grant an extension of time for the payment of the deficiency or any part thereof for a period not in excess of 18 months, and in exceptional cases for a further period not in excess of 12 months. The extension will not be granted upon a general statement of hardship. The term "undue hardship" means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, due to the sale of property at a sacrifice price, will result to the taxpayer from making payment of the deficiency at the due date. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship. The Act provides that no extension will be granted where the deficiency is due to negligence or intentional disregard of rules and regulations or to fraud with intent to evade tax.

An application for an extension of time for the payment of a deficiency should be made under oath on Form 1127 and must be accompanied or supported by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. A sworn statement of assets and liabilities of the taxpayer and an itemized statement under oath showing all receipts and disbursements for each of the three months immediately preceding the month in which falls the date prescribed for the payment of the deficiency are required and should accompany the application. The application, with the evidence, must be filed with the collector, who will transmit it to the Commissioner with his recommendations as to the extension. When it is received by the Commissioner, it will be examined and, if possible, within 30 days will be denied, granted, or tentatively granted subject to certain conditions of which the taxpayer will be notified. The Commissioner will not consider an application for an extension of time for the payment of a deficiency unless request therefor is made to the collector on or before the date prescribed for payment thereof, as shown by the notice and demand from the collector, or on or before the date or dates prescribed for payment in any prior extension granted.

As a condition to the granting of such an extension, the Commissioner will usually require the taxpayer to furnish a bond on Form 1127B in an amount not exceeding double the amount of the deficiency or to furnish other security satisfactory to the Commissioner for the payment of the liability on or before the date or dates prescribed for payment in the extension, so that the risk of loss to the Government will not be greater at the end of the extension period than it was at the beginning of the period. If a bond is required it shall be conditioned upon the payment of the deficiency, interest, and additional amounts assessed in connection therewith in accordance with the terms of the extension granted, and shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds, and shall be subject to the approval of the Commissioner. In lieu of such a bond, the taxpayer may file a bond secured by deposit of bonds or notes of the United States as provided in section 1126 of the Revenue Act of 1926, as amended by the Act entitled "An Act to amend the second Liberty Bond Act, as amended, and for other purposes," approved February 4, 1935 (49 Stat. 20). The amount of the deficiency and additions thereto shall be paid on or before the expiration of the period of the extension without the necessity of notice and demand from the collector. Payment of the deficiency and additions thereto before the expiration of the extension will not relieve the taxpayer from paying the entire amount of interest provided for in the extension. (See section 296.)

SEC. 273. *Jeopardy assessments.*—(a) *Authority for making.*—If the Commissioner believes that the assessment or collection of a deficiency will be jeopardized by delay, he shall immediately assess such deficiency (together with all interest, additional amounts, or additions to the tax provided for by law) and notice and demand shall be made by the collector for the payment thereof.

(b) *Deficiency letters.*—If the jeopardy assessment is made before any notice in respect of the tax to which the jeopardy assessment relates has been mailed under section 272 (a), then the Commissioner shall mail a notice under such subsection within sixty days after the making of the assessment.

(c) *Amount assessable before decision of Board.*—The jeopardy assessment may be made in respect of a deficiency greater or less than that notice of which has been mailed to the taxpayer, despite the provisions of section 272 (f) prohibiting the determination of additional deficiencies, and whether or not the taxpayer has theretofore filed a petition with the Board of Tax Appeals. The Commissioner may, at any time before the decision of the Board is rendered, abate such assessment, or any unpaid portion thereof, to the extent that he believes the assessment to be excessive in amount. The Commissioner shall notify the Board of the amount of such assessment, or abatement, if the petition is filed with the Board before the making of the assessment or is subsequently filed, and the Board shall have jurisdiction to redetermine the entire amount of the deficiency and of all amounts assessed at the same time in connection therewith.

(d) *Amount assessable after decision of Board.*—If the jeopardy assessment is made after the decision of the Board is rendered, such assessment may be made only in respect of the deficiency determined by the Board in its decision.

(e) *Expiration of right to assess.*—A jeopardy assessment may not be made after the decision of the Board has become final, or after the taxpayer has filed a petition for review of the decision of the Board.

(f) *Bond to stay collection.*—When a jeopardy assessment has been made the taxpayer, within 10 days after notice and demand from the collector for the payment of the amount of the assessment, may obtain a stay of collection of the whole or any part of the amount of the assessment by filing with the collector a bond in such amount, not exceeding double the amount as to which the stay is desired, and with such sureties, as the collector deems necessary, conditioned upon the payment of so much of the amount, the collection of which is stayed by the bond, as is not abated by a decision of the Board which has become final, together with interest thereon as provided in section 297. If any portion of the jeopardy assessment is abated by the Commissioner before the decision of the Board is rendered, the bond shall, at the request of the taxpayer, be proportionately reduced.

(g) *Same—Further conditions.*—If the bond is given before the taxpayer has filed his petition with the Board under section 272 (a), the bond shall contain a further condition that if a petition is not filed within the period provided in such subsection, then the amount the collection of which is stayed by the bond will be paid on notice and demand at any time after the expiration of such period, together with interest thereon at the rate of 6 per centum per annum from the date of the jeopardy notice and demand to the date of notice and demand under this subsection.

(h) *Waiver of stay.*—Upon the filing of the bond the collection of so much of the amount assessed as is covered by the bond shall be stayed. The taxpayer shall have the right to waive such stay at any time in respect of the whole or any part of the amount covered by the bond, and if as a result of such waiver any part of the amount covered by the bond is paid, then the bond shall, at the request of the taxpayer, be proportionately reduced. If the Board determines that the amount assessed is greater than the amount which should have been assessed, then when the decision of the Board is rendered the bond shall, at the request of the taxpayer, be proportionately reduced.

(i) *Collection of unpaid amounts.*—When the petition has been filed with the Board and when the amount which should have been assessed has been determined by a decision of the Board which has become final, then any unpaid portion, the collection of which has been stayed by the bond, shall be collected as part of the tax upon notice and demand from the collector, and any remaining portion of the assessment shall be abated. If the amount already collected exceeds the amount determined as the amount which should have been assessed, such excess shall be credited or refunded to the taxpayer as provided in section 322, without the filing of claim therefor. If the amount determined as the amount which should have been assessed is greater than the amount actually assessed, then the difference shall be assessed and shall be collected as part of the tax upon notice and demand from the collector.

(j) *Claims in abatement.*—No claim in abatement shall be filed in respect of any assessment in respect of any tax imposed by this title.

ART. 273-1. *Jeopardy assessments.*—If the Commissioner believes that the assessment or collection of a deficiency will be jeopardized by delay, he is required to assess such deficiency immediately, together with the interest and other additional amounts provided by law. If a deficiency is assessed on account of jeopardy after the decision of the Board of Tax Appeals is rendered, the jeopardy assessment may be made only with respect to the deficiency determined by the Board. The Commissioner is prohibited from making a jeopardy assessment after a decision of the Board has become final (see section 1005 of the Revenue Act of 1926, paragraph 16 of the Appendix to these regulations) or after the taxpayer has filed a petition for review of the decision of the Board.

If notice of a deficiency was mailed to the taxpayer (see section 272 (a)) before it was discovered that delay would jeopardize the assessment or collection of the tax, a jeopardy assessment may be made in an amount greater or less than that included in the deficiency notice. On the other hand if the assessment on account of jeopardy was made without mailing the notice required by section 272 (a), the Commissioner must within 60 days after the making of the assessment send the taxpayer notice of the deficiency by registered mail. The taxpayer may file a petition with the Board for a redetermination of the amount of the deficiency within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) after such notice is mailed. The Commissioner may, at any time before the decision of the Board is rendered, abate such assessment, or any unpaid portion thereof, to the extent that he believes the assessment to be excessive in amount. If the petition of the taxpayer is filed with the Board, either before or after the making of the jeopardy assessment, the Commissioner is required to notify the Board of such assessment or abatement, and the Board has jurisdiction to redetermine the amount of the deficiency together with all other amounts assessed at the same time in connection therewith. (See section 273 (c).)

After a jeopardy assessment has been made, the list showing such assessment will be immediately transmitted to the collector. Upon receipt of the list containing the assessment, the collector is required to send notice and demand to the taxpayer for the amount of the jeopardy assessment. Regardless of whether the taxpayer has filed a petition with the Board, he is required to make payment of the amount of such assessment (to the extent that it has not been abated) within 10 days after the sending of notice and demand by the collector, unless before the expiration of such 10-day period he files with the collector a bond on Form 1129 of the character hereinafter prescribed. The bond must be in such amount, not exceeding double the amount for which the stay is desired, as the collector deems necessary and must be executed by sureties satisfactory to the collector. It must be conditioned upon the payment of so much of the amount included therein as is not abated by a decision of the Board which has become final, together with the interest on such amount provided for in section 297. If the bond is given before the taxpayer has filed his petition with the Board, it must contain a further condition that if a petition is not filed before the expiration of the 90-day period provided for the filing of such petition, the amount stayed by the bond will be paid upon notice and demand at any time after the expiration of such period, together with interest thereon at the rate of 6 percent per annum from the date of the jeopardy notice and demand to the date of the notice and demand made after the expiration of the 90-day period. If a petition is not filed with the Board within the 90-day period, the collector will be so advised, and, if collection of the deficiency has been stayed by the filing of a bond within 10 days after the date of jeopardy notice and demand, he should then give notice and make demand for payment of the amount assessed plus interest. Any bond filed after the expiration of 10 days from the date of the jeopardy notice and demand is not such a bond as is contemplated by section 273 (f), and, while the collector may in his discretion accept the bond and stay collection of the deficiency, the taxpayer will not be relieved from payment of interest on the amount of the deficiency at the rate of 6 percent per annum from the date of the jeopardy notice and demand to the date of payment.

Upon the filing of a bond of the character described within 10 days after the date of notice and demand for payment of the amount assessed, the collection of so much thereof as is covered by the bond will be stayed. The taxpayer may at any time waive the stay of collection of the whole or any part of the amount covered by the bond. If as a result of such waiver any part of the amount covered by the bond is paid, or if any portion of the jeopardy assessment is abated by the Commissioner before the decision of the Board is rendered, then the bond shall at the request of the taxpayer be proportionately reduced. If the Board determines that the amount assessed is greater than the correct amount of the tax, the bond will also be proportionately reduced at the request of the taxpayer after the Board renders its decision.

After the Board has rendered its decision and such decision has become final, the collector will be notified of the action taken. The collector will then send notice and demand for the unpaid portion of the amount determined by the Board, the collection of which has been stayed by the bond. The collector is required to include in the notice and demand for the unpaid portion, interest at the rate of 6 percent per annum from the date of the jeopardy notice and demand to the date of the notice and demand referred to in this paragraph. If the amount of the jeopardy assessment is less than the amount determined by the Board, the difference, together with interest as provided in section 292, will be assessed, and collected as part of the tax upon notice and demand from the collector. If the amount included in the notice and demand made after the decision of the Board is not paid within 10 days after such notice and demand, there shall be collected as part of the tax, interest as provided in section 294 (b). If the amount of the jeopardy assessment is in excess of the amount determined by the Board, the unpaid portion of such excess will be abated. If any part of the excess amount has been paid, it will be credited or refunded to the taxpayer as provided in section 322.

As to bankruptcy, proceedings for the relief of debtors and receivership cases, see sections 274 and 298 and articles 274-1 and 274-2.

SEC. 274. *Bankruptcy and receiverships.*—(*a*) *Immediate assessment.*—Upon the adjudication of bankruptcy of any taxpayer in any bankruptcy proceeding or the appointment of a receiver for any taxpayer in any receivership proceeding before any court of the United States or of any State or Territory or of the District of Columbia, any deficiency (together with all interest, additional amounts, or additions to the tax provided for by law) determined by the Commissioner in respect of a tax imposed by this title upon such taxpayer shall, despite the restrictions imposed by section 272 (a) upon assessments be immediately assessed if such deficiency has not theretofore been assessed in accordance with law. In such cases the trustee in bankruptcy or receiver shall give notice in writing to the Commissioner of the adjudication of bankruptcy or the appointment of the receiver, and the running of the statute of limitations on the making of assessments shall be suspended for the period from the date of adjudication in bankruptcy or the appointment of the receiver to a date 30 days after the date upon which the notice from the trustee or receiver is received by the Commissioner; but the suspension under this sentence shall in no case be for a period in excess of two years. Claims for the deficiency and such interest, additional amounts and additions to the tax may be presented, for adjudication in accordance with law, to the court before which the bankruptcy or receivership proceeding is pending, despite the pendency of proceedings for the redetermination of the deficiency in pursuance of a petition to the Board; but no petition for any such redetermination shall be filed with the Board after the adjudication of bankruptcy or the appointment of the receiver.

(*b*) *Unpaid claims.*—Any portion of the claim allowed in such bankruptcy or receivership proceeding which is unpaid shall be paid by the taxpayer upon notice and demand from the collector after the termination of such proceeding, and may be collected by distraint or proceeding in court within six years after termination of such proceeding. Extensions of time for such payment may be had in the same manner and subject to the same provisions and limitations as are provided in section 272 (j) and section 296 in the case of a deficiency in a tax imposed by this title.

ART. 274-1. *Bankruptcy and receivership proceedings.*—During a bankruptcy proceeding, or an equity receivership proceeding in either a Federal or a State court, the assets of the taxpayer are in general under the control of the court in which such proceeding is pending, and the collection of taxes cannot be made by distraining upon such assets. However, any assets which under applicable provisions of law are not under the control of the court may be subject to distraint.

As used in these regulations the term "bankruptcy proceeding" includes proceedings under Chapters I to VII of the Bankruptcy Act, as amended, or under section 74, 75, 77, or 77B, or Chapters X to XIII, of such Act, as amended; and the term "adjudication of bankruptcy" includes, in addition to an adjudication in a proceeding under Chapters I to VII, the approval of a petition as properly filed under section 77 or 77B or Chapter X by a court of competent jurisdiction or the filing of a petition under section 74 or 75 or Chapters XI to XIII with a court of competent jurisdiction.

A trustee in bankruptcy (including a trustee, receiver, debtor in possession, or other person designated as in control of the assets of a debtor in any bankruptcy proceeding by order of the court in which such proceeding is pending) or a receiver in any receivership proceeding is required to give notice in writing to the Commissioner of Internal Revenue in Washington, D. C., of the adjudication of bankruptcy or the appointment of a receiver. (See section 274 (a) and article 275-1.)

Collectors should, promptly after notice of outstanding liability against a taxpayer in any bankruptcy or receivership proceedings, and in any event within the time limited by the appropriate provisions of the Bankruptcy Act, as amended, and the orders of the court in which such proceeding is pending, file claim covering such liability in the court in which such proceeding is pending. Such claim should be filed whether the unpaid taxes involved have been assessed or not, except in cases where the departmental instructions direct otherwise; for example, where the payment of the taxes is secured by a sufficient bond. Such claim should cover the amount represented by the assessment, plus interest at the rate of 6 percent per annum for the period from the date of filing claim by the collector to the date of termination of the bankruptcy or receivership proceeding or to the date of payment if payment is made in full prior to such termination. At the same time claim is filed with the bankruptcy or receivership court, the collector will send notice and demand for payment to the taxpayer together with a copy of such claim.

Under section 3466 of the Revised Statutes and section 3467 of the Revised Statutes, as amended (paragraphs 47 and 48, respectively, of the Appendix to these regulations), and section 64 of the Bankruptcy Act, as amended, taxes are entitled to the priority over other claims therein stated and the trustee, receiver, debtor in possession, or other person designated as in control of the assets of the debtor by the court in which bankruptcy or receivership proceeding is pending, may be held personally liable for failure on his part to protect the priority of the Government respecting taxes of which he has notice. Bankruptcy courts have jurisdiction under the Bankruptcy Act, as amended, to determine all disputes regarding the amount and validity of taxes of a bankrupt or of a debtor in a proceeding under the Bankruptcy Act, as amended. A bankruptcy or receivership proceeding does not discharge any portion of a claim of the United States for taxes except in the case of a proceeding under Chapter X of the Bankruptcy Act, as amended, and except to the extent which may be provided in a plan or arrangement duly effectuated in a bankruptcy proceeding; and any portion of a claim of the United States for taxes which has been allowed by the court in which the bankruptcy or receivership proceeding is pending and which remains unsatisfied after the termination of the bankruptcy or receivership proceeding shall be collected with interest as provided in section 298.

ART. 274-2. *Immediate assessments in bankruptcy and receivership cases.*—If the Commissioner has determined that a deficiency is due in respect of income tax and the taxpayer has filed a petition with the Board of Tax Appeals prior to the adjudication of bankruptcy or the appointment of a receiver, the trustee, receiver, debtor in possession, or other person designated as in control of the assets of the debtor by the court in which the bankruptcy or receivership proceeding is pending, may prosecute the taxpayer's appeal before the Board as to that particular determination. No petition shall be filed with the Board for a redetermination of the deficiency after the adjudication of bankruptcy or the appointment of a receiver.

Claim for the amount of a deficiency, even though pending before the Board for consideration, may be filed with the court in which the bankruptcy or receivership proceeding is pending without awaiting final decision of the Board. In case of final decision of the Board before the termination of the bankruptcy, debtor, or receivership proceeding, a copy of the Board's decision may be filed by the Commissioner with the court in which such proceeding is pending.

While the Commissioner is required by section 274 to make immediate assessment of any deficiency, such assessment is not made as a jeopardy assessment within the meaning of section 273, and consequently the provisions of that section do not apply to any assessment made under section 274. Therefore, the notice of the deficiency provided for in section 273 (b) will not be mailed. Although such notice will not be issued, nevertheless a letter will be sent to the taxpayer, or to the trustee, receiver, debtor in possession, or other person designated by the court in which the bankruptcy or receivership proceeding is pending as in control of the assets of the debtor, notifying him in detail how the deficiency was computed, that he may furnish evidence showing wherein the deficiency is incorrect, and that upon request he will be granted a hearing with respect to such deficiency. If after such evidence is submitted and hearing held any adjustment appears necessary in the deficiency, appropriate action will be taken. A copy of the notification letter will be attached to the assessment list as the collector's authority for filing claim in any bankruptcy or receivership proceeding.

If any portion of the claim allowed by the court in a bankruptcy or receivership proceeding remains unpaid after the termination of such proceeding, the collector will send notice and demand for payment thereof to the taxpayer. Such unpaid portion with interest as provided in section 298 may be collected from the taxpayer by distraint or proceeding in court within six years after the termination of the bankruptcy or receivership proceeding. Extensions of time for the payment of such unpaid amount may be granted in the same manner and subject to the same provisions and limitations as provided in sections 272 (j) and 297. (See article 272-3.)

This article deals only with immediate assessments provided for in section 274 and the procedure in connection with such assessments.

SEC. 275. *Period of limitation upon assessment and collection.*—Except as provided in section 276—

(*a*) *General rule.*—The amount of income taxes imposed by this title shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

(*b*) *Request for prompt assessment.*—In the case of income received during the lifetime of a decedent, or by his estate during the period of administration, or by a corporation, the tax shall be assessed, and any proceeding in court without assessment for the collection of such tax shall be begun, within eighteen months after written request therefor (filed after the return is made) by the executor, administrator, or other fiduciary representing the estate of such decedent, or by the corporation, but not after the expiration of three years after the return was filed. This subsection shall not apply in the case of a corporation unless—

(1) Such written request notifies the Commissioner that the corporation contemplates dissolution at or before the expiration of such 18 months' period; and

(2) The dissolution is in good faith begun before the expiration of such 18 months' period; and

(3) The dissolution is completed.

(*c*) *Omission from gross income.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

(*d*) *Shareholders of foreign personal holding companies.*—If the taxpayer omits from gross income an amount properly includible therein under section 337 (b) (relating to the inclusion in the gross income of United States shareholders of their distributive shares of the undistributed Supplement P net income of a foreign personal holding company) the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within seven years after the return was filed.

(*e*) *Distributions in liquidation to shareholders.*—If the taxpayer omits from gross income an amount properly includible therein under section 115 (c) as an amount distributed in liquidation of a corporation, other than a foreign personal holding company, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within four years after the return was filed.

(*f*) For the purposes of subsections (a), (b), (c), (d), and (e), a return filed before the last day prescribed by law for the filing thereof shall be considered as filed on such last day.

(*g*) *Corporation and shareholder.*—If a corporation makes no return of the tax imposed by this title, but each of the shareholders includes in his return his distributive share of the net income of the corporation, then the tax of the corporation shall be assessed within four years after the last date on which any such shareholder's return was filed.

SEC. 276. *Same—Exceptions.*—(*a*) *False return or no return.*—In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

(*b*) *Waiver.*—Where before the expiration of the time prescribed in section 275 for the assessment of the tax, both the Commissioner and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

(*c*) *Collection after assessment.*—Where the assessment of any income tax imposed by this title has been made within the period of limitation properly applicable thereto, such tax may be collected by distraint or by a proceeding in court, but only if begun (1) within six years after the assessment of the tax, or (2) prior to the expiration of any period for collection agreed upon in writing by the Commissioner and the taxpayer before the expiration of such six-year period. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

SEC. 277. *Suspension of running of statute.*—The running of the statute of limitations provided in section 275 or 276 on the making of assessments and the beginning of distraint or a proceeding in court for collection, in respect of any deficiency, shall (after the mailing of a notice under section 272 (a)) be suspended for the period during which the Commissioner is prohibited from making the assessment or beginning distraint or a proceeding in court (and in any event, if a proceeding in respect of the deficiency is placed on the docket of the Board, until the decision of the Board becomes final), and for sixty days thereafter.

ART. 275-1. *Period of limitation upon assessment of tax.*—The amount of income tax imposed by the Act must be assessed within three years after the return was filed. For the purposes of subsections (a), (b), (c), (d), and (e) of section 275, a return filed before the last day prescribed by law for the filing thereof shall be considered as filed on such last day. Exceptions to the period of limitation stated in this paragraph (other than those provided for elsewhere than in the internal revenue laws) are as follows:

(1) In the case of income received during the lifetime of a decedent or by his estate during the period of administration, or by a corporation contemplating dissolution, the tax shall be assessed within 18 months after written request therefor by the fiduciary or legal representative of the estate of the decedent or by the corporation, but not after the expiration of 3 years after the return was filed. The effect of this provision is to limit the period in which the Commissioner may assess the tax in such cases to a period of 18 months from the date the request is filed, even though more than 18 months still remain of the regular 3-year period in which the assessment may under ordinary circumstances be made. The request, in order to be effective, must be made after the return is filed and must be in such language as to make it clear to the Commissioner that it is desired to take advantage of the provisions of section 275 (b). In the case of a corporation the 18-month period of limitation shall not apply unless—

(*a*) the written request notifies the Commissioner that the corporation contemplates dissolution at or before the expiration of such period,

(*b*) the dissolution is in good faith begun before the expiration of such period, and

(*c*) the dissolution so begun is completed either before or after the expiration of such 18-month period.

Such a request does not have the effect of extending the regular period of limitation even though the request is made less than 18 months before the expiration of the regular period of limitation.

(2) If a corporation makes no income tax return under the Act, but each of the shareholders includes in his personal return his distributive share of the net income of the corporation, the tax of the corporation shall be assessed within four years after the last date on which any such shareholder's return was filed.

(3) In the case of a false or fraudulent return with intent to evade tax, the tax may be assessed at any time after such false or fraudulent return is filed.

(4) If there is omitted from the gross income stated in the return an amount properly includible therein which is in excess of 25 percent of the gross income so stated, the tax may be assessed at any time within five years after the return was filed.

(5) In the event the taxpayer fails to file a return, the amount of tax due may be assessed at any time after the date prescribed for filing the return. (But see paragraph (2) of this article.)

(6) If the taxpayer omits from gross income an amount properly includible therein under section 337 (b) as his distributive share of the undistributed Supplement P net income of a foreign personal holding company, the tax may be assessed at any time within seven years after the return was filed.

(7) If the taxpayer omits from gross income an amount properly includible therein under section 115 (c) as an

amount distributed in liquidation of a corporation, other than a foreign personal holding company, the tax may be assessed at any time within four years after the return was filed.

(8) If before the expiration of the time prescribed in section 275 for the assessment of the tax the Commissioner and the taxpayer have consented in writing to the assessment of the tax after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

(9) If a notice of a deficiency has been mailed to the taxpayer under the provisions of section 272 (a), then the running of the statute of limitations on assessment of any deficiency shall be suspended for the period during which the Commissioner is prohibited from making the assessment (and in any event, if a proceeding in respect of the deficiency is placed on the docket of the Board, until the decision of the Board becomes final), and for 60 days thereafter. If the Commissioner mails to a taxpayer a notice of deficiency within the statutory period of limitation and the taxpayer does not appeal therefrom to the Board, the notice of deficiency so given does not suspend the running of the period of limitation on assessment for the purpose of any additional deficiency shown to be due in a subsequent deficiency notice.

(10) In a bankruptcy or receivership proceeding the running of the statute of limitations on the making of assessments is suspended from the date of adjudication in bankruptcy or the date of the appointment of a receiver, as the case may be, to a date 30 days after the date upon which the notice provided for in section 274 (a) is received by the Commissioner in Washington, D. C., but in no case shall the suspension be for a period in excess of two years. See section 274 (a) and articles 274-1 and 274-2.

With respect to the period of limitation for assessing the amount of the liability of a transferee of property, or for assessing the amount of the liability of a fiduciary under section 3467 of the Revised Statutes, as amended (paragraph 48 of the Appendix to these regulations), see section 311.

ART. 275-2. *Period of limitation upon collection of tax.*—In the case of the income taxes imposed by the Act, a proceeding in court without assessment for the collection of such tax must be begun within three years after the return was filed.

The exceptions to the period of limitation upon collection of the tax without assessment stated in the preceding paragraph are as follows:

(1) In the case of income received during the lifetime of a decedent or by his estate during the period of administration, or by a corporation, a proceeding in court for the collection of the tax without assessment must be begun within 18 months after a written request therefor by the executor, administrator, or other fiduciary representing the estate of the decedent or by the corporation, but not after the expiration of 3 years after the return was filed. Such a request does not have the effect of extending the regular period of limitation within which a proceeding in court without assessment may be begun, even though the request is made less than 18 months before the expiration of the regular period of limitation, nor is it of any effect if made before the return is filed. In the case of a corporation the conditions stated in *(a)*, *(b)*, and *(c)* of paragraph (1) of article 275-1 also must be met.

(2) A proceeding in court for the collection of the tax without assessment may be begun at any time—

(a) In case the taxpayer files a false or fraudulent return with intent to evade tax; and

(b) In case the taxpayer failed to file a return.

(3) If there is omitted from the gross income stated in the return an amount properly includible therein which is in excess of 25 percent of the gross income so stated, a proceeding in court for the collection of the tax may be begun without assessment at any time within five years after the return was filed.

(4) If the taxpayer omits from gross income an amount properly includible therein under section 337 (b) as his distributive share of the undistributed Supplement P net income of a foreign personal holding company, a proceeding in court for the collection of the tax may be begun without assessment at any time within seven years after the return was filed.

(5) If the taxpayer omits from gross income an amount properly includible therein under section 115 (c) as an amount distributed in liquidation of a corporation, other than a foreign personal holding company, a proceeding in court for the collection of the tax may be begun without assessment at any time within four years after the return was filed.

In any case in which the tax has been assessed within the statutory period of limitation properly applicable thereto, a proceeding in court or distraint for the collection of such tax may be begun within six years after the assessment thereof, or prior to the expiration of any period for collection agreed upon in writing by the Commissioner and the taxpayer before the expiration of such 6-year period. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon. In determining the running of the statute of limitations in respect of distraint, the distraint shall be held to have been begun, in the case of personal property, on the date on which the levy upon such property is made, or, in the case of real property, on the date on which notice of the time and place of sale is given to the person whose estate it is proposed to sell.

If a notice of a deficiency has been mailed to the taxpayer under the provisions of section 272 (a) (see article 272-1), then the running of the statute of limitations on the beginning of distraint after assessment, or on the beginning of a proceeding in court after assessment or without assessment, in respect of any deficiency, shall be suspended for the period during which the Commissioner is prohibited from beginning such distraint or proceeding in court (and in any event, if a proceeding in respect of the deficiency is placed on the docket of the Board, until the decision of the Board becomes final), and for 60 days thereafter.

With respect to the period of limitation upon the collection of the tax on unpaid claims in bankruptcy or receivership proceedings, see section 274 (b) and article 274-2.

CHAPTER XXXI

Interest and Additions to Tax

Supplement M—Interest and Additions to the Tax

SEC. 291. *Failure to file return.*—In case of any failure to make and file return required by this title, within the time prescribed by law or prescribed by the Commissioner in pursuance of law, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the tax: 5 per centum if the failure is for not more than thirty days with an additional 5 per centum for each additional thirty days or fraction thereof during which such failure continues, not exceeding 25 per centum in the aggregate. The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, in which case the amount so added shall be collected in the same manner as the tax. The amount added to the tax under this section shall be in lieu of the 25 per centum addition to the tax provided in section 3176 of the Revised Statutes, as amended.

ART. 291-1. *Addition to the tax in case of failure to file return.*—In case of failure to make and file a return required by Title I within the prescribed time, a certain percent of the amount of the tax is added to the tax unless the return is later filed and failure to file the return within the prescribed time is shown to the satisfaction of the Commissioner to be due to reasonable cause and not to willful neglect. The amount to be added to the tax is 5 percent if the failure is for not more than 30 days, with an additional 5 percent for each additional 30 days or fraction thereof during which failure continues, not to exceed 25 percent in the aggregate. Two classes of delinquents are subject to this addition to the tax:

(*a*) Those who do not file returns and for whom returns are made by a collector, a deputy collector, or the Commissioner, and

(*b*) Those who file tardy returns and are unable to show reasonable cause for the delay.

A taxpayer who files a tardy return and wishes to avoid the addition to the tax for delinquency must make an affirmative showing of all facts alleged as a reasonable cause for failure to file the return on time in the form of an affidavit which should be attached to the return. If such an affidavit is furnished with the return or upon the collector's demand, the collector, unless otherwise directed by the Commissioner, will forward the affidavit with the return, and, if the Commissioner determines that the delinquency was due to a reasonable cause, and not to willful neglect, the addition to the tax will not be assessed. If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause.

If the addition to the tax for delinquency in filing the return has been added, the amount so added shall be collected in the same manner as the tax.

For addition to the tax in case of a deficiency due to fraud with intent to evade tax, see section 293. As to the making of returns for taxpayers by collectors or the Commissioner in the case of delinquency in filing a return, or in the case of a false or fraudulent return, see section 3176 of the Revised Statutes, as amended (paragraph 65 of the Appendix to these regulations).

SEC. 292. *Interest on deficiencies.*—Interest upon the amount determined as a deficiency shall be assessed at the same time as the deficiency, shall be paid upon notice and demand from the collector, and shall be collected as a part of the tax, at the rate of 6 per centum per annum from the date prescribed for the payment of the tax (or, if the tax is paid in installments, from the date prescribed for the payment of the first installment) to the date the deficiency is assessed, or, in the case of a waiver under section 272 (d), to the thirtieth day after the filing of such waiver or to the date the deficiency is assessed whichever is the earlier.

SEC. 293. *Additions to the tax in case of deficiency.*—(*a*) *Negligence.*—If any part of any deficiency is due to negligence, or intentional disregard of rules and regulations but without intent to defraud, 5 per centum of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected, and paid in the same manner as if it were a deficiency, except that the provisions of section 272 (i), relating to the prorating of a deficiency, and of section 292, relating to interest on deficiencies, shall not be applicable.

(*b*) *Fraud.*—If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3176 of the Revised Statutes, as amended.

SEC. 294. *Additions to the tax in case of nonpayment.*—(*a*) *Tax shown on return.*—(1) *General rule.*—Where the amount determined by the taxpayer as the tax imposed by this title, or any installment thereof, or any part of such amount or installment, is not paid on or before the date prescribed for its payment, there shall be collected as a part of the tax, interest upon such unpaid amount at the rate of 6 per centum per annum from the date prescribed for its payment until it is paid.

(2) *If extension granted.*—Where an extension of time for payment of the amount so determined as the tax by the taxpayer, or any installment thereof, has been granted, and the amount the time for payment of which has been extended, and the interest thereon determined under section 295, is not paid in full prior to the expiration of the period of the extension, then, in lieu of the interest provided for in paragraph (1) of this subsection, interest at the rate of 6 per centum per annum shall be collected on such unpaid amount from the date of the expiration of the period of the extension until it is paid.

(*b*) *Deficiency.*—Where a deficiency, or any interest or additional amounts assessed in connection therewith under section 292, or under section 293, or any addition to the tax in case of delinquency provided for in section 291, is not paid in full within ten days from the date of notice and demand from the collector, there shall be collected as part of the tax, interest upon the unpaid amount at the rate of 6 per centum per annum from the date of such notice and demand until it is paid. If any part of a deficiency prorated to any unpaid installment under section 272 (i) is not paid in full on or before the date prescribed for the payment of such installment, there shall be collected as part of the tax interest upon the unpaid amount at the rate of 6 per centum per annum from such date until it is paid.

(*c*) *Filing of jeopardy bond.*—If a bond is filed, as provided in section 273, the provisions of subsection (b) of this section shall not apply to the amount covered by the bond.

SEC. 295. *Time extended for payment of tax shown on return.*—If the time for payment of the amount determined as the tax by the taxpayer, or any installment thereof, is extended under the authority of section 56 (c), there shall be collected as a part of such amount, interest thereon at the rate of 6 per centum per annum from the date when such payment should have been made if no extension had been granted, until the expiration of the period of the extension.

SEC. 296. *Time extended for payment of deficiency.*—If the time for the payment of any part of a deficiency is extended, there shall be collected, as a part of the tax, interest on the part of the deficiency the time for payment of which is so extended, at the rate of 6 per centum per annum for the period of the extension, and no other interest shall be collected on such part of the deficiency for such period. If the part of the deficiency the time for payment of which is so extended is not paid in accordance with the terms of the extension, there shall be collected, as a part of the tax, interest on such unpaid amount at the rate of 6 per centum per annum for the period from the time fixed by the terms of the extension for its payment until it is paid, and no other interest shall be collected on such unpaid amount for such period.

SEC. 297. *Interest in case of jeopardy assessments.*—In the case of the amount collected under section 273 (i) there shall be collected at the same time as such amount, and as a part of the tax, interest at the rate of 6 percentum per annum upon such amount from the date of the jeopardy notice and demand to the date of notice and demand under section 273 (i), or, in the case of the amount collected in excess of the amount of the jeopardy assessment, interest as provided in section 292. If the amount included in the notice and demand from the collector under section 273 (i) is not paid in full within ten days after such notice and demand, then there shall be collected, as part of the tax, interest upon the unpaid amount at the rate of 6 per centum per annum from the date of such notice and demand until it is paid.

SEC. 298. *Bankruptcy and receiverships.*—If the unpaid portion of the claim allowed in a bankruptcy or receivership proceeding, as provided in section 274, is not paid in full within ten days from the date of notice and demand from the collector, then there shall be collected as a part of such amount interest upon the unpaid portion thereof at the rate of 6 per centum per annum from the date of such notice and demand until payment.

SEC. 299. *Removal of property or departure from United States.*—For additions to tax in case of leaving the United States or concealing property in such manner as to hinder collection of the tax, see section 146.

CHAPTER XXXII

Claims Against Transferees and Fiduciaries

Supplement N—Claims Against Transferees and Fiduciaries

SEC. 311. *Transferred assets.*—(*a*) *Method of collection.*—The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this title (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds):

(1) *Transferees.*—The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this title.

(2) *Fiduciaries.*—The liability of a fiduciary under section 3467 of the Revised Statutes in respect of the payment of any such tax from the estate of the taxpayer.

Any such liability may be either as to the amount of tax shown on the return or as to any deficiency in tax.

(*b*) *Period of limitation.*—The period of limitation for assessment of any such liability of a transferee or fiduciary shall be as follows:

(1) In the case of the liability of an initial transferee of the property of the taxpayer,—within one year after the expiration of the period of limitation for assessment against the taxpayer;

(2) In the case of the liability of a transferee of a transferee of the property of the taxpayer,—within one year after the expiration of the period of limitation for assessment against the preceding transferee, but only if within three years after the expiration of the period of limitation for assessment against the taxpayer;—

except that if before the expiration of the period of limitation for the assessment of the liability of the transferee, a court proceeding for the collection of the tax or liability in respect thereof has been begun, against the taxpayer or last preceding transferee, respectively,—then the period of limitation for assessment of the liability of the transferee shall expire one year after the return of execution in the court proceeding.

(3) In the case of the liability of a fiduciary,—not later than one year after the liability arises or not later than the expiration of the period for collection of the tax

in respect of which such liability arises, whichever is the later;

(4) Where before the expiration of the time prescribed in paragraph (1), (2), or (3) for the assessment of the liability, both the Commissioner and the transferee or fiduciary have consented in writing to its assessment after such time, the liability may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

(c) *Period for assessment against taxpayer.*—For the purposes of this section, if the taxpayer is deceased, or in the case of a corporation, has terminated its existence, the period of limitation for assessment against the taxpayer shall be the period that would be in effect had death or termination of existence not occurred.

(d) *Suspension of running of statute of limitations.*—The running of the statute of limitations upon the assessment of the liability of a transferee or fiduciary shall, after the mailing to the transferee or fiduciary of the notice provided for in section 272 (a), be suspended for the period during which the Commissioner is prohibited from making the assessment in respect of the liability of the transferee or fiduciary (and in any event, if a proceeding in respect of the liability is placed on the docket of the Board, until the decision of the Board becomes final), and for sixty days thereafter.

(e) *Address for notice of liability.*—In the absence of notice to the Commissioner under section 312 (b) of the existence of a fiduciary relationship, notice of liability enforceable under this section in respect of a tax imposed by this title, if mailed to the person subject to the liability at his last known address, shall be sufficient for the purposes of this title even if such person is deceased, or is under a legal disability, or, in the case of a corporation, has terminated its existence.

(f) *Definition of "transferee".*—As used in this section, the term "transferee" includes heir, legatee, devisee, and distributee.

ART. 311-1. *Claims in cases of transferred assets.*—The amount for which a transferee of the property of a taxpayer is liable, at law or in equity, and the amount of the personal liability of a fiduciary under section 3467 of the Revised Statutes, as amended, in respect of any income tax imposed by the Act (paragraph 48 of the Appendix to these regulations), whether shown on the return of the taxpayer or determined as a deficiency in the tax, shall be assessed against such transferee or such fiduciary, as the case may be, and collected and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by the Act, except as hereinafter provided. The provisions relating to delinquency in payment after notice and demand and the amount of interest attaching because of such delinquency, the authorization of distraint and proceedings in court for collection, the prohibition of claims for abatement and claims and suits for refund, the filing of a petition with the Board of Tax Appeals, and the filing of a petition for review of the Board's decision, are included in the sections and articles relating to deficiencies in tax imposed by Title I.

The term "transferee" as used in this article includes an heir, legatee, devisee, distributee of an estate of a deceased person, the shareholder of a dissolved corporation, the assignee or donee of an insolvent person, the successor of a corporation, a party to a reorganization as defined in section 112, and all other classes of distributees.

The period of limitation for assessment of the liability of a transferee or of a fiduciary, referred to in the first paragraph of this article, is as follows:

(1) In the case of the liability of an initial transferee of the property of the taxpayer one year after the expiration of the period of limitation for assessment against the taxpayer (see sections 275-277);

(2) In the case of the liability of a transferee of a transferee of the property of the taxpayer, one year after the expiration of the period of limitation for assessment against the preceding transferee, or three years after the expiration of the period of limitation for assessment against the taxpayer, whichever of the two periods (the 1-year period or the 3-year period) first expires;

(3) If a court proceeding against the taxpayer or last preceding transferee for the collection of the tax or liability in respect thereof, respectively, has been begun within the period of limitation for the bringing of such proceeding, then within one year after the return of execution in such proceeding; and

(4) In the case of the liability of a fiduciary, not later than one year after the liability arises or not later than the expiration of the period for collection of the tax in respect of which such liability arises, whichever is the later.

(5) If before the expiration of the time prescribed in section 311 (b) (1), (2) or (3) for the assessment of the liability of a transferee or fiduciary, both the Commissioner and the transferee or fiduciary have consented in writing to the assessment of the liability after such time, the liability may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

For the purpose of determining the period of limitation for assessment against a transferee or a fiduciary, if the taxpayer is deceased, or, in the case of a corporation, has terminated its existence, the period of limitation for assessment against the taxpayer shall be the period that would be in effect had the death or termination of existence not occurred.

If a notice of the liability of a transferee or the liability of a fiduciary has been mailed to such transferee or to such fiduciary under the provisions of section 272 (a), then the running of the statute of limitations shall be suspended for the period during which the Commissioner is prohibited from making the assessment in respect of the liability of the transferee or fiduciary (and in any event, if a proceeding in respect of the liability is placed on the docket of the Board, until the decision of the Board becomes final), and for 60 days thereafter.

SEC. 312. *Notice of fiduciary relationship.*—(a) *Fiduciary of taxpayer.*—Upon notice to the Commissioner that any person is acting in a fiduciary capacity such fiduciary shall assume the powers, rights, duties, and privileges of the taxpayer in respect of a tax imposed by this title (except as otherwise specifically provided and except that the tax shall be collected from the estate of the taxpayer), until notice is given that the fiduciary capacity has terminated.

(b) *Fiduciary of transferee.*—Upon notice to the Commissioner that any person is acting in a fiduciary capacity for a person subject to the liability specified in section 311, the fiduciary shall assume, on behalf of such person, the powers, rights, duties, and privileges of such person under such section (except that the liability shall be collected from the estate of such person), until notice is given that the fiduciary capacity has terminated.

(c) *Manner of notice.*—Notice under subsection (a) or (b) shall be given in accordance with regulations prescribed by the Commissioner with the approval of the Secretary.

ART. 312-1. *Fiduciaries.*—As soon as the Commissioner receives notice that a person is acting in a fiduciary capacity, such fiduciary must, except as otherwise specifically provided, assume the powers, rights, duties, and privileges of the taxpayer with respect to income tax imposed by Title I. If the person is acting as a fiduciary for a transferee or other person subject to the liability specified in section 311, such fiduciary is required to assume the powers, rights, duties, and privileges of the transferee or other person under that section. The amount of the tax or liability is ordinarily not collectible from the personal estate of the fiduciary but is collectible from the estate of the taxpayer or from the estate of the transferee or other person subject to the liability specified in section 311. The "notice to the Commissioner" provided for in section 312 shall be a written notice signed by the fiduciary and filed with the Commissioner. The notice must state the name and address of the person for whom the fiduciary is acting, and the nature of the liability of such person; that is, whether it is a liability for tax, and, if so, the year or years involved, or a liability at law or in equity of a transferee of property of a taxpayer, or a liability of a fiduciary under section 3467 of the Revised Statutes, as amended (paragraph 48 of the Appendix to these regulations), in respect of the payment of any tax from the estate of the taxpayer. Any such written notice which has been filed with the Commissioner since the enactment of the Revenue Act of 1926 shall be considered as sufficient notice to the Commissioner within the meaning of section 312. Unless there is already on file with the Commissioner satisfactory evidence of the authority of the fiduciary to act for such person in a fiduciary capacity, such evidence must be filed with and made a part of the notice. If the fiduciary capacity exists by order of court, a certified copy of the order may be regarded as such satisfactory evidence. When the fiduciary capacity has terminated, the fiduciary in order to be relieved of any further duty or liability as such, must file with the Commissioner written notice that the fiduciary capacity has terminated as to him, accompanied by satisfactory evidence of the termination of the fiduciary capacity. The notice of termination should state the name and address of the person, if any, who has been substituted as fiduciary.

If the notice of the fiduciary capacity described in the preceding paragraph is not filed with the Commissioner prior to the sending of notice of a deficiency by registered mail to the last known address of the taxpayer (see section 272 (a)), or the last known address of the transferee or other person subject to liability (see section 311), no notice of the deficiency will be sent to the fiduciary. In such a case the sending of the notice to the last known address of the taxpayer, transferee, or other person, as the case may be, will be a sufficient compliance with the requirements of the Act, even though such taxpayer, transferee, or other person is deceased, or is under a legal disability, or, in the case of a corporation, has terminated its existence. Under such circumstances if no petition is filed with the Board of Tax Appeals before the expiration of 90 days from the sending of the notice to the taxpayer, transferee, or other person, the tax, or liability under section 311, will be assessed immediately upon the expiration of such 90-day period, and demand for payment will be made by the collector. The term "fiduciary" is defined in section 901 (a) (6) to mean a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.

This article, relating to the provisions of section 312, shall not be taken to abridge in any way the powers and duties of fiduciaries provided for in other sections of the Act.

CHAPTER XXXIII

Overpayments

Supplement O—Overpayments

SEC. 321. *Overpayment of installment.*—If the taxpayer has paid as an installment of the tax more than the amount determined to be the correct amount of such installment, the overpayment shall be credited against the unpaid installments, if any. If the amount already paid, whether or not on the basis of installments, exceeds the amount determined to be the correct amount of the tax, the overpayment shall be credited or refunded as provided in section 322.

SEC. 322. *Refunds and credits.*—(a) *Authorization.*—Where there has been an overpayment of any tax imposed by this title, the amount of such overpayment shall be credited against any income, war-profits, or excess-profits tax or installment thereof then due from the taxpayer, and any balance shall be refunded immediately to the taxpayer.

(b) *Limitation on allowance.*—(1) *Period of limitation.*—Unless a claim for credit or refund is filed by the taxpayer within three years from the time the return was filed by the taxpayer or within two years from the time the tax was paid, no credit or refund shall be allowed or made after the expiration of whichever of such periods expires the later. If no return is filed by the taxpayer, then no credit or refund shall be allowed or made after two years from the time the tax was paid, unless before the expiration of such period a claim therefor is filed by the taxpayer.

(2) *Limit on amount of credit or refund.*—The amount of the credit or refund shall not exceed the portion of the tax paid during the three years immediately preceding the filing of the claim, or, if no claim was filed, then during the three years immediately preceding the allowance of the credit or refund.

(c) *Effect of petition to Board.*—If the Commissioner has mailed to the taxpayer a notice of deficiency under section 272 (a) and if the taxpayer files a petition with the Board of Tax Appeals within the time prescribed in such subsection, no credit or refund in respect of the tax for the taxable year in respect of which the Commissioner has determined the deficiency shall be allowed or made and no suit by the taxpayer for the recovery of any part of such tax shall be instituted in any court except—

(1) As to overpayments determined by a decision of the Board which has become final; and

(2) As to any amount collected in excess of an amount computed in accordance with the decision of the Board which has become final; and

(3) As to any amount collected after the period of limitation upon the beginning of distraint or a proceeding in court for collection has expired; but in any such claim for credit or refund or in any such suit for refund the decision of the Board which has become final, as to whether such period has expired before the notice of deficiency was mailed, shall be conclusive.

(d) *Overpayment found by Board.*—If the Board finds that there is no deficiency and further finds that the taxpayer has made an overpayment of tax in respect of the taxable year in respect of which the Commissioner determined the deficiency, the Board shall have jurisdiction to determine the amount of such overpayment, and such amount shall, when the decision of the Board has become final, be credited or refunded to the taxpayer. No such credit or refund shall be made of any portion of the tax unless the Board determines as part of its decision that such portion was paid (1) within three years before the filing of the claim or the filing of the petition, whichever is earlier, or (2) after the mailing of the notice of deficiency.

(e) *Tax withheld at source.*—For refund or credit in case of excessive withholding at the source, see section 143 (f).

ART. 322-1. *Authority for abatement, credit, and refund of tax.*—Authority for the credit and refund of any overpayment of any income tax imposed by Title I is contained in section 322.

Section 273 (j) prohibits the filing of claims for abatement by taxpayers with respect to assessments of income tax imposed by Title I.

ART. 322-2. *Credit and refund adjustments.*—Overassessments and overpayments of income taxes will be adjusted by means of certificates of overassessment. Credits or refunds of overpayments on the basis of such certificates of overassessment may not be allowed or made, however, after the expiration of the statutory period of limitation properly applicable unless prior to the expiration of such period a claim therefor on Form 843 has been filed by the taxpayer. The claim, together with appropriate supporting evidence, must be filed in the office of the collector for the district in which the tax was paid. Where an amount of tax in excess of that properly due has been paid by a withholding agent, the credit or refund of such excess amount shall be made to the withholding agent unless the amount of such tax was actually withheld by the withholding agent. (See section 143 (f).) As to interest in case of credits or refunds, see section 614 of the Revenue Act of 1928, as amended by section 804 of the Revenue Act of 1936 (paragraph 42 of the Appendix to these regulations), and section 177, United States Judicial Code, as amended by section 615 of the Revenue Act of 1928 and section 808 of the Revenue Act of 1936 (paragraph 43 of the Appendix to these regulations).

ART. 322-3. *Claims for refund by taxpayers.*—Claims by the taxpayer for the refunding of taxes, interest, penalties, and additions to tax erroneously or illegally collected shall be made on Form 843, and should be filed with the collector of internal revenue. A separate claim on such form shall be made for each taxable year or period.

The claim must set forth in detail and under oath each ground upon which a refund is claimed, and facts sufficient to apprise the Commissioner of the exact basis thereof. No refund or credit will be allowed after the expiration of the statutory period of limitation applicable to the filing of a claim therefor except upon one or more of the grounds set forth in a claim filed prior to the expiration of such period. A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund. With respect to limitations upon the refunding or crediting of taxes, see article 322-7.

If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter a refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made in the claim showing that the return was filed by the fiduciary and that the latter is still acting. In such cases, if a refund or interest is to be paid, letters testamentary, letters of administration, or other evidence may be required, but should be submitted only upon the receipt of a specific request therefor. If a claim is filed by a fiduciary other than the one by whom the return was filed, the necessary documentary evidence should accompany the claim. The affidavit may be made by the agent of the person assessed, but in such case a power of attorney must accompany the claim.

Checks in payment of claims allowed will be drawn in the names of the persons entitled to the money and may be sent to such persons in care of an attorney or agent who has filed a power of attorney specifically authorizing him to receive such checks. The Commissioner may, however, send any such check direct to the claimant. In this connection, see section 3477 of the Revised Statutes, which provides:

SEC. 3477. All transfers and assignments made of any claim upon the United States, or of any part or share thereof, or interest therein, whether absolute or conditional, and whatever may be the consideration therefor, and all powers of attorney, orders, or other authorities for receiving payment of any such claim, or of any part or share thereof, shall be absolutely null and void, unless they are freely made and executed in the presence of at least two attesting witnesses, after the allowance of such a claim, the ascertainment of the amount due, and the issuing of a warrant for the payment thereof. Such transfers, assignments, and powers of attorney, must recite the warrant for payment, and must be acknowledged by the person making them, before an officer having authority to take acknowledgments of deeds and shall be certified by the officer; and it must appear by the certificate that the officer, at the time of the acknowledgment, read and fully explained the transfer, assignment, or warrant of attorney to the person acknowledging the same.

The Commissioner has no authority to refund on equitable grounds penalties or other amounts legally collected. As to claims for refund of sums recovered by suit, see articles 322-4 to 322-6.

ART. 322-4. *Claim for payment of judgment obtained against collector.*—(*a*) A claim for the amount of a judgment against a collector of internal revenue for the recovery of taxes, penalties, or other sums should be made under oath, on Form 843, and filed directly with the Commissioner of Internal Revenue, Washington, D. C. Two certified copies of the final judgment and a certificate of probable cause should be attached to the claim. If the payment of court costs is claimed, an itemized bill of the court costs paid, receipted by the clerk of the court, should also accompany the claim. With respect to the certificate of probable cause, section 989 of the Revised Statutes provides:

SEC. 989. When a recovery is had in any suit or proceeding against a collector or other officer of the revenue for any act done by him, or for the recovery of any money exacted by or paid to him and by him paid into the Treasury, in the performance of his official duty, and the court certifies that there was probable cause for the act done by the collector or other officer, or that he acted under the directions of the Secretary of the Treasury, or other proper officer of the Government, no execution shall issue against such collector or other officer, but the amount so recovered shall, upon final judgment, be provided for and paid out of the proper appropriation from the Treasury.

If the case was appealed, two certified copies of the mandate of the appellate court should also be attached to the claim. A judgment will not be paid until the period for appeal has expired unless a stipulation, signed by both parties to the suit, waiving the right to appeal, has been filed with the clerk of the court, and two certified copies of such waiver are furnished to the Commissioner.

(*b*) If the judgment debtor shall have already paid the amount recovered against him, the claim should be made in his name, accompanied by two certified copies of the final judgment, and an itemized bill of the court costs paid. A certificate of the clerk of the court in which the judgment was recovered (or other satisfactory evidence), showing that the judgment has been satisfied and specifying the exact sum paid in its satisfaction, should accompany the claim. (See further article 322-3.)

ART. 322-5. *Claim for payment of judgment obtained in United States district court against the United States.*—A claim for the payment of a judgment rendered by a United States district court against the United States representing taxes, penalties, or other sums should be made under oath, on Form 843, in duplicate, and filed directly with the Commissioner of Internal Revenue, Washington, D. C. Two certified copies of the final judgment should be attached to the claim. If the judgment specifically provides for the recovery of costs, an itemized bill of such court costs paid, receipted by the clerk of the court, should also accompany the claim. If the case was appealed, two certified copies of the mandate of the appellate court should also be attached to the claim. A judgment will not be paid until the period for appeal has expired unless a stipulation, signed by both parties to the suit, waiving the right to appeal, has been filed with the clerk of the court, and two certified copies of such waiver are furnished to the Commissioner.

ART. 322-6. *Claim for payment of judgment obtained in the Court of Claims against the United States.*—A claim for the payment of a judgment rendered by the United States Court of Claims against the United States, representing taxes, penalties, or other sums should be made under oath, on Form 843, in duplicate, and filed directly with the Commissioner of Internal Revenue, Washington, D. C., accompanied by a certificate of judgment issued by the clerk of the court and two copies of the printed opinion of the court, if an opinion was rendered. A judgment will not be paid until the period for appeal has expired unless a stipulation, signed by both parties to the suit, waiving the right to appeal, has been filed with the clerk of the court, and two certified copies of such waiver are furnished to the Commissioner.

ART. 322-7. *Limitations upon the crediting and refunding of taxes paid.*—(*a*) Unless a claim for credit or refund is filed within three years from the time the return was filed by the taxpayer or within two years from the time the tax was paid, the Commissioner is prohibited from allowing or making a credit or refund of income tax imposed by Title I after both periods have expired. If no return is filed by the taxpayer, the Commissioner is prohibited from allowing or making a credit or refund of such tax after two years from the time the tax was paid unless before the expiration of such 2-year period a claim therefor is filed. The amount of the credit or refund in any case shall not exceed the portion of the tax paid during the 3-year period immediately preceding the date of the allowance of the credit or refund, or, if the credit or refund is based upon a claim, the amount of the credit or refund shall not exceed the portion of the tax paid during the 3-year period immediately preceding the date of filing such claim. The provisions of this paragraph are subject to the exceptions provided in paragraph (*b*) of this article.

(*b*) In any case where a person having a right to file a petition with the Board of Tax Appeals with respect to a deficiency in income tax imposed by the Act files such petition within the prescribed time, no credit or refund of the tax for the year to which the deficiency relates shall be allowed or made, and no suit for the recovery of any part of such tax shall be instituted by the taxpayer, except that—

(1) If the Board finds that there is no deficiency but that the person has overpaid his tax for the year to which the notice of deficiency relates, and the decision of the Board as to the amount overpaid has become final (see section 1005 of the Revenue Act of 1926), the overpayment shall be credited or refunded, but no such credit or refund shall be made of any portion of the tax unless the Board determines as part of its decision that such portion was paid (A) not earlier than three years before the filing of the refund claim therefor or the filing of the petition, whichever event occurs first in point of time, or if no claim is filed, not earlier than three years before the filing of the petition, or (B) after the mailing of the notice of deficiency.

(2) In the case of a jeopardy assessment made under section 273, if the amount which should have been assessed as determined by a decision of the Board

which has become final is less than the amount already collected, the excess payment shall be credited or refunded subject to a determination being made by the Board with respect to the time of payment as stated in (*b*) (1) of this article.

(3) If the amount of the deficiency determined by the Board (in a case where collection has not been stayed by the filing of a bond) is disallowed in whole or in part by the reviewing court, then the overpayment resulting from such disallowance shall be credited or refunded without the making of claim therefor subject to a determination being made by the Board with respect to the time of payment as stated in (*b*) (1) of this article. (See section 1001 (d) of the Revenue Act of 1926, as amended, paragraph 13 of the Appendix to these regulations.)

(4) Where the amount collected is in excess of the amount computed in accordance with the decision of the Board which has become final, the excess payment shall be credited or refunded within the period of limitation provided in section 322 (b).

(5) Where an amount is collected after the statutory period of limitation upon the beginning of distraint or a proceeding in court for collection has expired (see article 275-2), the taxpayer may file a claim for refund of the amount so collected within the period of limitation provided in section 322 (b). In any such case, the decision of the Board as to whether the statutory period upon collection of the tax expired before notice of the deficiency was mailed shall, when the decision becomes final, be conclusive.

ART. 322-8. *Crediting of accounts of collectors in cases of assessments against several persons covering same liability.*—If assessments have been made against several persons covering the same tax liability, and payment of such liability by one or more of such persons has been duly certified to the Commissioner, the Commissioner, for the purpose of temporarily relieving the collector from liability under section 3218 of the Revised Statutes, may authorize him to take credit temporarily with respect to the assessments not specifically paid. Such action, however, shall not constitute an abatement and shall not discharge the liability of the persons concerned.

* * * * * *

[*Chapters XXXIV–XXXVIII and the Appendix will appear in the "Federal Register" for Tuesday, February 14, 1939.*]

[SEAL] GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved: February 7, 1939.

H. MORGENTHAU, Jr.,
Secretary of the Treasury.

[F. R. Doc. 39-450; Filed, February 7, 1939; 4:01 p. m.]

TITLE 30—MINERAL RESOURCES

NATIONAL BITUMINOUS COAL COMMISSION

[General Docket No. 15]

ESTABLISHMENT OF MINIMUM PRICES AND MARKETING RULES AND REGULATIONS

CORRECTION OF ERRORS IN SCHEDULES OF APPROVED MINIMUM PRICES FOR DISTRICTS NOS. 7 AND 8

Order

It appearing that in the schedule of minimum prices approved by the Commission for District No. 7,[1] being the Appendix to the Findings of the Commission in the above-entitled matter, the coal of the Carter Coal Company in Size Group #5 produced at the Caretta #5 Mine, #4 Sub-district, in the War Creek Seam, by reason of a typographical error, was classified as "A" instead of Class "D," as originally proposed by the Board and as found by the Commission, and

It further appearing that in the schedule of minimum prices approved by the Commission for District No. 8,[2] being the Appendix to the Findings of the Commission for District No. 8, the coal of the West Virginia Coal and Coke Corporation's Earling Mine in Size Group 26, by reason of a typographical error, was classified "G" instead of "J" as the same was modified by the Commission in its Findings entered herein, and

It further appearing that in said schedule of minimum prices for District No. 8, the coals of the Ajax Coal Company in Size Groups 21 to 25, both inclusive, were classified as "k" instead of "L," as modified by the Commission in its Fndings, and

It further appearing that in the said schedule of minimum prices for District No. 8, the coals of the Red Jacket Coal Corporation in Size Group 26, by reason of typographical errors, were given no classification, although the Commission found that these coals should be classified as follows: Mitchell Branch Mine, "J"; Junior Mine, "K"; # 5 Mine, "N"; # 6 Mine, "F"; # 32 Top Mine, "M"; and # 32 Bottom Mine, "K."

Now, therefore, It is ordered that the schedule of minimum prices approved by the Commission for District No. 7, to serve as the basis for coordination, be and the same is hereby corrected by changing the classification therein appearing for Size Group 5 of the Caretta Mine of the Carter Coal Company from Class "A" to Class "D," and

It is further ordered that the schedule of minimum prices approved by the Commission for District No. 8, to serve as a basis for coordination, be corrected in the following respects:

The classification of the West Virginia Coal and Coke Corporation's Earling Mine in Size Group 26 be and the same is hereby changed from "G" to "J."

The classification of Size Groups 21 to 25, both inclusive, produced at the Ajax Mine of the Ajax Coal Company, be and the same are hereby changed from Classification "K" to Classification "L."

The following mines of the Red Jacket Coal Corporation in Size Group 26 are classified as follows: Mitchell Branch Mine, "J"; Junior Mine, "K"; #5 Mine, "N"; #6 Mine, "F"; #32 Top Mine, "M"; #32 Bottom Mine, "K."

The Secretary of the Commission is hereby directed to cause a copy of this Order to be included in the docket containing the record of the proceedings in the matter of the proposal of minimum prices by the District Boards for Districts Nos. 7 and 8 in General Docket No. 15, and shall cause a copy of this Order to be published forthwith in the FEDERAL REGISTER, and shall cause a copy hereof to be mailed to the Secretary of each District Board, to each code member in Districts Nos. 7 and 8, to the Consumers' Counsel, and to all parties who have filed their appearances in the hearing relating to the proposals submitted by the District Boards for Districts Nos. 7 and 8, and shall cause a copy hereof to be made available for inspection at the office of the Secretary of the Commission, Washington, D. C., and at the office of each Statistical Bureau of the Commission.

By order of the Commission.

Dated this 8th day of February, 1939.

[SEAL] F. WITCHER MCCULLOUGH,
Secretary.

[F. R. Doc. 39-483; Filed, February 10, 1939; 10:05 a. m.]

[1] 4 F. R. 307 DI.
[2] 4 F. R. 328 DI.

Notices

DEPARTMENT OF THE INTERIOR.

National Bituminous Coal Commission.

[Docket No. 4-FD]

APPLICATION OF SMOKELESS COAL CORPORATION FOR PROVISIONAL APPROVAL AS MARKETING AGENCY

PETITION FOR APPROVAL OF CHANGES IN FORMS OF CONTRACTS BETWEEN THE CORPORTATION AND PRODUCERS AND SUB-AGENTS

Notice and Order for Hearing

The petitioner above-named, having on the 25th day of January, 1939, filed its petition for approval of changes in forms of contracts between the corporation and producers and sub-agents, *Notice is hereby given* That the above-entitled matter is assigned for hearing before an Examiner of the Commission on the 1st day of March, 1939, at ten o'clock a. m., at the hearing room of the Commission, Walker Building, 734 15th Street, N. W., Washington, D. C., at which time and place interested parties will be afforded an opportunity to be heard.

FEDERAL REGISTER

VOLUME 4 NUMBER 30

Washington, Tuesday, February 14, 1939

Rules, Regulations, Orders

TITLE 14—CIVIL AVIATION

CIVIL AERONAUTICS AUTHORITY

[Amendment 4]

AMENDMENT OF REGULATION 601-A-1[1] OF THE CIVIL AIR REGULATIONS RELATIVE TO EQUIPMENT

At a session of the Civil Aeronautics Authority held at its office in Washington, D. C., on the 10th day of February 1939.

Acting pursuant to the authority vested in it by the Civil Aeronautics Act of 1938, particularly Sections 205 (a) and 601 (a) of said Act, and finding that its action is desirable in the public interest and is necessary to carry out the provisions of, and to exercise and perform its powers and duties under said Act, the Civil Aeronautics Authority hereby amends the Civil Air Regulations as follows:

[Amendment No. 4 of Civil Air Regulations]

REQUIRING A MANUFACTURER'S AIRCRAFT OPERATING MANUAL WHEN REQUIRED BY THE APPROVED TYPE CERTIFICATE OR TYPE CERTIFICATE TO BE CARRIED IN THE AIRCRAFT AT ALL TIMES

Sec. 04.5 of the Civil Air Regulations is hereby amended by adding at the end thereof a new subsection 04.504:

"04.504 A manufacturer's aircraft operating manual, when required by the approved type certificate, type certificate, or approved specification which is part thereof, and when such manufacturer's aircraft operating manual has been approved by the Authority, shall be carried in the pilots' compartment at all times."

For the Authority:

[SEAL] PAUL J. FRIZZELL,
Secretary.

[F. R. Doc. 39-535; Filed, February 13, 1939; 11:49 a. m.]

[1] 3 F. R. 2051 DI.

TITLE 16—COMMERCIAL PRACTICES

FEDERAL TRADE COMMISSION

IN THE MATTER OF PHILIP MORRIS & CO., LTD., INC.

SEC. 3.99 (b) *Using or selling lottery devices—In merchandising.* Selling, etc., in connection with offer, etc., in interstate commerce or in District of Columbia, of cigarets or any other merchandise, cigarets or other merchandise so packed, etc., that sales thereof to the public are to be, or may be, made by means of a lottery, etc., as specified, prohibited. (Sec. 5b, 52 Stat. 112; 15 U. S. C., Supp. IV, sec. 45b) [Cease and desist order, Philip Morris & Co., Ltd., Inc., Docket 3398, January 31, 1939]

SEC. 3.99 (b) *Using or selling lottery devices—In merchandising.* Supplying, etc., dealers, in connection with offer, etc., in interstate commerce or in District of Columbia, of cigarets or any other merchandise, assortments of said cigarets or other merchandise, together with punch boards or other lottery devices which are to be, or may be, used in selling, etc., such cigarets, etc., to the public, prohibited. (Sec. 5b, 52 Stat. 112; 15 U. S. C., Supp. IV, sec. 45b) [Cease and desist order, Philip Morris & Co., Ltd., Inc., Docket 3398, January 31, 1939]

SEC. 3.99 (b) *Using or selling lottery devices — In merchandising.* Supplying, etc., dealers, in connection with offer, etc.,

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RULES, REGULATIONS, ORDERS

(Continued on next page)

TITLE 26—INTERNAL REVENUE

BUREAU OF INTERNAL REVENUE

[Regulations 101]

INCOME TAX UNDER THE REVENUE ACT OF 1938

[*The Table of Contents and Chapters I–IX appeared in the "Federal Register" for Friday, February 10, 1939. Chapters X–XXXIII appeared in the "Federal Register" for Saturday, February 11, 1939.*]

CHAPTER XXXIV

Foreign Personal Holding Companies

Supplement P—Foreign Personal Holding Companies

SEC. 331. *Definition of foreign personal holding company.*—(*a*) *General rule.*—For the purposes of this title the term "foreign personal holding company" means any foreign corporation if—

(1) *Gross income requirement.*—At least 60 per centum of its gross income (as defined in section 334 (a)) for the taxable year is foreign personal holding company income as defined in section 332; but if the corporation is a foreign personal holding company with respect to any taxable year ending after August 26, 1937, then for each subsequent taxable year, the minimum percentage shall be 50 per centum in lieu of 60 per centum, until a taxable year during the whole of which the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than 50 per centum of the gross income is foreign personal holding company income. For the purposes of this paragraph there shall be included in the gross income the amount includible therein as a dividend by reason of the application of section 334 (c) (2); and

(2) *Stock ownership requirement.*—At any time during the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, hereinafter called "United States group".

(*b*) *Exceptions.*—The term "foreign personal holding company" does not include a corporation exempt from taxation under section 101.

ART. 331–1. *Definition of foreign personal holding company.*—A foreign personal holding company is any foreign corporation (other than a corporation exempt from taxation under section 101) which for the taxable year meets (*a*) the gross income requirements specified in article 331–2, and (*b*) the stock ownership requirement specified in article 331–3. Both requirements must be satisfied and both must be met with respect to each taxable year.

A foreign corporation which comes within the classification of a foreign personal holding company for any taxable year beginning after December 31, 1937, is not subject to taxation for such taxable year either under section 102 or section 401 but may be subject to taxation under either of those sections for other taxable years. The fact that a foreign corporation is a foreign personal holding company does not relieve the corporation from liability for the taxes imposed generally under section 231 upon foreign corporations, since such taxes apply regardless of the classification of the foreign corporation as a foreign personal holding company.

ART. 331–2. *Gross income requirement.*—To meet the gross income requirement, it is necessary that either of the following percentages of gross income of the corporation for the taxable year (including the additions to gross income provided in seection 334 (b) as required by seection 334 (c) (2)) be foreign personal holding company income as defined in section 332:

(*a*) 60 percent or more; or

(*b*) 50 percent or more if the foreign corporation has been classified as a foreign personal holding company for any taxable year ending after August 26, 1937, unless—

(1) a taxable year has intervened since the last taxable year for which it was so classified, during no part of which the stock ownership requirement specified in section 331 (a) (2) exists; or

(2) three consecutive years have intervened since the last taxable year for which it was so classified, during each of which its foreign personal holding company income was less than 50 percent of its gross income.

In determining whether the foreign personal holding company income is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts. For a further discussion of what constitutes "gross income," see section 22 (a) and the regulations prescribed under that section.

ART. 331–3. *Stock ownership requirement.*—To meet the stock ownership requirement, it is necessary that at some time in the taxable year more than 50 percent in value of the outstanding stock of the foreign corporation be owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, hereinafter referred to as "United States group." For such purpose, the ownership of the stock must be determined as provided in section 333 and articles 333 (a)–1 to 333 (a)–7 and article 333 (b)–1.

In the event of any change in the stock outstanding during the taxable year, whether in the number of shares or classes of stock, or whether in the ownership thereof, the conditions existing immediately prior and subsequent to each change must be taken into consideration, since a corporation comes within the classification if the statutory conditions with respect to stock ownership are present *at any time* during the taxable year.

In determining whether the statutory conditions with respect to stock ownership are present at any time during the taxable year, the phrase "in value" shall, in the light of all the circumstances, be deemed the value of the corporate stock outstanding at such time (not including treasury stock). This value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock which is used is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class therein.

SEC. 332. *Foreign personal holding company income.*—For the purposes of this title the term "foreign personal holding company income" means the portion, of the gross income determined for the purposes of section 331 (a) (1), which consists of:

(*a*) Dividends, interest, royalties, annuities,

(*b*) *Stock and securities transactions.*—Except in the case of regular dealers in stock or securities, gains from the sale or exchange of stock or securities.

(*c*) *Commodities transactions.*—Gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. This subsection shall not apply to gains by a producer, processor, merchant, or handler of the commodity which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others.

(*d*) *Estates and trusts.*—Amounts includible in computing the net income of the corporation under Supplement E; and gains from the sale or other disposition of any interest in an estate or trust.

(*e*) *Personal service contracts.*—(1) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and (2) amounts received from the sale or other disposition of such a contract. This subsection shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 per centum or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

(*f*) *Use of corporation property by shareholder.*—Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25 per centum or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property; whether such right is obtained directly from the corporation or by means of a sublease or other arrangement.

(*g*) *Rents.*—Rents, unless constituting 50 per centum or more of the gross income. For the purposes of this subsection the term "rents" means compensation, however designated, for the use of, or right to use, property; but does not include amounts constituting foreign personal holding company income under subsection (f).

ART. 332–1. *Foreign personal holding company income.*—For the purposes of Supplement P and these regulations the term "foreign personal holding company income" means the portion of the gross income determined for the purposes of section 331 (a) (1) and article 331-2 which consists of the following:

(1) *Dividends.*—The term "dividends" includes dividends as defined in section 115 (a) and amounts required to be included in gross income under section 334 (b). It does not include stock dividends (to the extent they do not constitute income to the shareholders within the meaning of the sixteenth amendment to the Constitution), liquidating dividends, or other capital distributions referred to in section 115 (c) and (d).

(2) *Interest.*—The term "interest" means any amounts, includible in gross income, received for the use of money loaned.

(3) *Royalties.*—The term "royalties" includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property. It does not include rents, or overriding royalties received by an operating company. As used in this paragraph the term "overriding royalties" means amounts received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid.

(4) *Annuities.*—The term "annuities" includes annuities only to the extent includible in the computation of gross income. (See section 22 (b) (2).)

(5) *Gains from the sale or exchange of stock or securities.*—The term "gains from the sale or exchange of stock or securities" as used in section 332 (b) applies to all gains (including gains from liquidating dividends and other distributions from capital) from the sale or exchange of stock or securities includible in gross income. The term "stock or securities" as used in section 332 (b) includes shares or certificates of stock, or interest in any corporation (including any joint-stock company, insurance company, association, or other organization classified as a corporation by the Act), certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral royalty, or lease, collateral trust certificates, voting trust certificates, stock rights or warrants, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange, obligations issued by or on behalf of a Government, State, Territory, or political subdivision thereof. In the case of "regular dealers in stock or securities" the term does not include gains derived from the sale or exchange of stock or securities made in the normal course of business. The term "regular dealers in stock or securities" as used in section 332 (b) means corporations with an established place of business regularly engaged in the purchase of stock or securities and their resale to customers, but such corporations are not dealers with respect to stock or securities held for speculation or investment.

(6) *Gains from futures transactions in commodities.*—Gains from futures transactions in commodities include gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, but do not include gains from cash transactions or gains by a producer, processor, merchant, or handler of the commodity, which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. In general, foreign personal holding company income includes gains on futures contracts which are speculative. Futures contracts representing true hedges against price fluctuations in spot goods are not speculative transactions, though not concurrent with spot transactions. Futures contracts which are not hedges against spot transactions are speculative unless they are hedges against concurrent futures or forward sales or purchases.

(7) *Income from estates and trusts.*—The income from estates and trusts which is to be included in foreign personal holding company income consists of the income from estates and trusts which is required to be included in the gross income of the corporation under sections 161 to 169, together with the gains derived by the corporation from the sale or other disposition of any interest in an estate or trust.

(8) *Amounts received under personal service contracts.*—Amounts includible in foreign personal holding company income as amounts received under personal service contracts consist of amounts received pursuant to a contract under which the corporation is to furnish personal services, and amounts received from a sale or other disposition of such a contract, if—

(*a*) Some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description in the contract); and

(*b*) at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description), as the one to perform such services. For this purpose the stock ownership must be determined as provided in section 333 and articles 333 (a)-1 to 333 (a)-7 and article 333 (b)-1.

The application of section 332 (e) may be illustrated by the following examples:

Example (1): A, whose profession is that of an actor, owns all of the outstanding capital stock of the M Corporation, a foreign corporation. The M Corporation entered into a contract with A under which A was to perform personal services for the person or persons which the M Corporation might designate, in consideration of which A was to receive $10,000 a year from the M Corporation. The M Corporation entered into a contract with the O Corporation in which A was designated to perform personal services for the O Corporation, in consideration of which the O Corporation was to pay the M Corporation $500,000 a year. The $500,000 received by the M Corporation from the O Corporation constitutes foreign personal holding company income.

Example (2): The N Corporation, a foreign corporation, the entire outstanding capital stock of which is owned by four individuals, is engaged in engineering. The N Corporation entered into a contract with the O Corporation to perform engineering services for the O Corporation, in consideration of which the O Corporation was to pay the N Corporation $50,000. The individual who was to perform the services was not designated (by name or by description) in the contract and no one but the N Corporation had the right to designate (by name or by description) such individual. The $50,000 received by the N Corporation from the O Corporation does not constitute foreign personal holding company income.

(9) *Compensation for use of property.*—The compensation for the use of, or the right to use, property of the corporation which is to be included in foreign personal holding company income consists of amounts received as compensation (however designated and from whomsoever received) for the use of, or the right to use, property of the corporation in any case in which, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property, whether such right is obtained directly from the corporation or by means of a sublease or other arrangement. The property may consist of a yacht, a city residence, a country house, or any other kind of property. See sections 331 (a) (2) and 333 and articles 333 (a)-1 to 333 (a)-7 and article 333 (b)-1.

(10) *Rents.*—The rents which are to be included in foreign personal holding company income consist of compensation, however designated, including charter fees, etc., for the use of, or the right to use, real property, or any other kind of property, but do not include amounts constituting foreign personal holding company income under section 332 (f) and paragraph (9) of this article. However, rents do not constitute foreign personal holding company in-

come if constituting 50 percent or more of the gross income of the corporation.

SEC. 333. *Stock ownership.—(a) Constructive ownership.*—For the purpose of determining whether a foreign corporation is a foreign personal holding company, insofar as such determination is based on stock ownership under section 331 (a) (2), section 332 (e), or section 332 (f)—

(1) *Stock not owned by individual.*—Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.

(2) *Family and partnership ownership.*—An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For the purposes of this paragraph the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(3) *Options.*—If any person has an option to acquire stock such stock shall be considered as owned by such person. For the purposes of this paragraph an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(4) *Application of family-partnership and option rules.*—Paragraphs (2) and (3) shall be applied—

(A) For the purposes of the stock ownership requirement provided in section 331 (a) (2), if, but only if, the effect is to make the corporation a foreign personal holding company;

(B) For the purposes of section 332 (e) (relating to personal service contracts), or of section 332 (f) (relating to the use of property by shareholders), if, but only if, the effect is to make the amounts therein referred to includible under such subsection as foreign personal holding company income.

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

(6) *Option rule in lieu of family and partnership rule.*—If stock may be considered as owned by an individual under either paragraph (2) or (3) it shall be considered as owned by him under paragraph (3).

ART. 333 (a)-1. *Stock ownership.*—For the purpose of determining whether—

(*a*) a foreign corporation is a foreign personal holding company, in so far as such determination is based on the stock ownership requirement specified in section 331 (a) (2) and article 331-3, or

(*b*) amounts received under a personal service contract or from the sale of such a contract constitute foreign personal holding company income in so far as such determination is based on the stock ownership requirement specified in section 332 (e) and paragraph (8) of article 332-1, or

(*c*) compensation for the use of property constitutes foreign personal holding company income in so far as such determination is based on the stock ownership requirement specified in section 332 (f) and paragraph (9) of article 332-1,

stock owned by an individual includes stock constructively owned by him as provided in section 333. For such purpose constructive ownership of stock shall be determined and applied in accordance with the rules provided in section 333 and articles 333 (a)-2 to 333 (a)-7 and article 333 (b)-1. All forms and classes of stock, however denominated, which represent the interests of shareholders, members, or beneficiaries in the corporation shall be taken into consideration.

ART. 333 (a)-2. *Stock not owned by individual.*—In determining the ownership of stock for any of the purposes set forth in article 333 (a)-1, stock owned directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. For example, if A and B, two individuals, are the exclusive and equal beneficiaries of a trust or estate, and if such trust or estate owns the entire capital stock of the M Corporation, and if the M Corporation in turn owns the entire capital stock of the N Corporation, then the stock of both the M Corporation and the N Corporation shall be considered as being owned equally by A and B as the individuals owning the beneficial interest therein. See also article 333 (a)-6.

ART. 333 (a)-3. *Family and partnership ownership.*—In determining the ownership of stock for any of the purposes set forth in article 333 (a)-1, an individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For the purposes of such determination the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

The application of the family and partnership rule in determining the ownership of stock for the purpose set forth in (*a*) of article 333 (a)-1 is illustrated by the following example:

Example: The M Corporation at some time during the taxable year had 1,800 shares of outstanding stock, 450 of which were held by various individuals having no relationship to one another and none of whom were partners, and the remaining 1,350 were held by 51 shareholders as follows:

Relationships	Shares		Shares		Shares		Shares		Shares	
An individual	A	100	B	20	C	20	D	20	E	20
His father	AF	10	BF	10	CF	10	DF	10	EF	10
His wife	AW	10	BW	40	CW	40	DW	40	EW	40
His brother	AB	10	BB	10	CB	10	DB	10	EB	10
His son	AS	10	BS	40	CS	40	DS	40	ES	40
His daughter by former marriage (son's half-sister)	ASHS	10	BSHS	40	CSHS	40	DSHS	40	ESHS	40
His brother's wife	ABW	10	BBW	10	CBW	10	DBW	160	EBW	10
His wife's father	AWF	10	BWF	10	CWF	110	DWF	10	EWF	10
His wife's brother	AWB	10	BWB	10	CWB	10	DWB	10	EWB	10
His wife's brother's wife	AWBW	10	BWBW	10	CWBW	10	DWBW	10	EWBW	110
Individual's partner	AP	10								

By applying the statutory rule provided in section 333 (a) (2) five individuals own more than 50 percent of the outstanding stock as follows:

A (including AF, AW, AB, AS, ASHS, AP)	160
B (including BF, BW, BB, BS, BSHS)	160
CW (including C, CS, CWF, CWB)	220
DB (including D, DF, DBW)	200
EWB (including EW, EWF, EWBW)	170
Total, or more than 50 percent	910

Individual A represents the obvious case where the head of the family owns the bulk of the family stock and naturally is the head of the group. A's partner owns 10 shares of the stock. Individual B represents the case where he is still head of the group because of the ownership of stock by his immediate family. Individuals C and D represent cases where the individuals fall in groups headed in C's case by his wife and in D's case by his brother because of the preponderance of holdings on the part of relatives by marriage. Individual E represents the case where the preponderant holdings of others eliminate that individual from the group.

The method of applying the family and partnership rule as illustrated in the foregoing example also applies in determining the ownership of stock for the purposes stated in (*b*) and (*c*) of article 333 (a)-1.

ART. 333 (a)-4. *Options.*—In determining the ownership of stock for any of the purposes set forth in article 333 (a)-1, if any person has an option to acquire stock, such stock may be considered as owned by such person. The term "option" as used in this article includes an option to acquire such an option and each one of a series of such options, so that the person who has an option on an option to acquire stock may be considered as the owner of the stock.

ART. 333 (a)-5. *Application of family-partnership and option rules.*—The family and partnership rule provided in section 333 (a) (2) and article 333 (a)-3 and the option rule provided in section 333 (a) (3) and article 333 (a)-4 shall be applied—

(*a*) for the purpose stated in (*a*) of article 333 (a)-1, if, but only if, the effect of such application is to make the foreign corporation a foreign personal holding company, or

(*b*) for the purpose stated in (*b*) of article 333 (a)-1, if, but only if, the effect of such application is to make the amounts received under a personal service contract or from the sale of such a contract foreign personal holding company income, or

(*c*) for the purpose stated in (*c*) of article 333 (a)-1, if, but only if, the effect of such application is to make the compensation for the use of property foreign personal holding company income.

The family and partnership rule and the option rule must be applied independently for each of the purposes stated in article 333 (a)-1.

ART. 333 (a)-6. *Constructive ownership as actual ownership.*—In determining the ownership of stock for any of the purposes set forth in article 333 (a)-1—

(*a*) stock constructively owned by a person by reason of the application of the rule provided in section 333 (a) (1) relating to stock not owned by an individual (see article 333 (a)-2 shall be considered as actually owned by such person for the purpose of again applying such rule or of applying the family and partnership rule provided in section 333 (a) (2) (see article 333 (a)-3) in order to make another person the constructive owner of such stock, and

(*b*) stock constructively owned by a person by reason of the application of the option rule provided in section 333 (a) (3) (see article 333 (a)-4) shall be considered as actually owned by such person for the purpose of applying either the rule provided in section 333 (a) (1), relating to stock not owned by an individual, or the family and partnership rule provided in section 333 (a) (2) in order to make another person the constructive owner of such stock, but

(*c*) stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 333 (a) (2) shall not be considered as actually owned by such individual for the purpose of again applying such rule in order to make another individual the constructive owner of such stock.

The application of this article may be illustrated by the following examples:

Example (1): A is a United States citizen, whose wife, AW, owns all of the stock of the M Corporation, which in turn owns all the stock of the O Corporation. The O Corporation in turn owns all the stock in the P Corporation.

Under the rule provided in section 333 (a) (1), relating to stock not owned by an individual, the stock in the P Corporation owned by the O Corporation is considered to be owned constructively by the M Corporation, the sole shareholder of the O Corporation. Such constructive ownership of the stock by the M Corporation is considered as actual ownership for the purpose of again applying such rule in order to make AW, the sole shareholder of the M Corporation, the constructive owner of the stock of the P Corporation. Similarly, the constructive ownership of the stock by AW is considered as actual ownership for the purpose of applying the family and partnership rule provided in section 333 (a) (2) in order to make A the constructive owner of the stock of the P Corporation, if such application is necessary for any of the purposes set forth in article 333 (a)-1. But the stock thus constructively owned by A may not be considered as actual ownership for the purpose of again applying the family and partnership rule in order to make another member of A's family, for example A's father, the constructive owner of the stock of the P Corporation.

Example (2): B is a United States citizen who owns all the stock of the R Corporation which has an option to acquire all the stock of the S Corporation, a foreign corporation, owned by C, an individual, who is not related to B.

Under the option rule provided in section 333 (a) (3) the R Corporation may be considered as owning constructively the stock of the S Corporation owned by C. Such constructive ownership of the stock by the R Corporation is considered as actual ownership for the purpose of applying the rule provided in section 333 (a) (1), relating to stock not owned by an individual, in order to make B, the sole shareholder of the R Corporation, the constructive owner of the stock of the S Corporation. The stock thus constructively owned by B by reason of the application of the rule provided in section 333 (a) (1) likewise is considered as actual ownership for the purpose, if necessary, of applying the family and partnership rule provided in section 333 (a) (2), in order to make another member of B's family, for example, B's wife, BW, the constructive owner of the stock of the S Corporation. However, the family and partnership rule could not again be applied so as to make still another individual the constructive owner of the stock of the S. Corporation, that is, the stock constructively owned by BW could not be considered as actually owned by her in order to make BW's father the constructive owner of such stock by a second application of the family and partnership rule.

ART. 333 (a)-7. *Option rule in lieu of family and partnership rule.*—If, in determining the ownership of stock for any of the purposes set forth in article 333 (a)-1, stock may be considered as constructively owned by an individual by an application of both the family-partnership rule provided in section 333 (a) (2) (see article 333 (a)-3) and the option rule provided in section 333 (a) (3) (see article 333 (a)-4) such stock shall be considered as owned constructively by the individual by reason of the application of the option rule.

The application of this article may be illustrated by the following example:

Example: Two brothers, A and B, each own 10 percent of the stock of the M Corporation, a foreign corporation, and A's wife, AW, also owns 10 percent of the stock of such corporation. AW's husband, A, has an option to acquire the stock owned by her at any time. It becomes necessary, for one of the purposes stated in article 333 (a)-1, to determine the stock ownership of B in the M Corporation.

If the family and partnership rule were the only rule that applied in the case, B would be considered, under that rule, as owning 20 percent of the stock of the M Corporation, namely, his own stock plus the stock owned by his brother. In that event, B could not be considered as owning the stock held by AW since (1) AW is not a member of B's family and (2) the constructive ownership of such stock by A through the application of the family and partnership rule in his case is not considered as actual ownership so as to make B the constructive owner by a second application of the same rule with respect to the ownership of the stock. (See article 333 (a)-6.)

However, there is more than the family and partnership rule involved in this example. As the holder of an option upon the stock, A may be considered the constructive owner of his wife's stock by the application of the option rule and without reference to the family relationship between A and AW. If A is considered as owning the stock of his wife by application of the option rule, then under article 333 (a)-6, such constructive ownership by A is regarded as actual ownership for the purpose of applying the family and partnership rule so as to make another member of A's family, for example, B, the constructive owner of the stock. Hence, since A may be considered as owning his wife's stock by applying both the family-partnership rule and the option rule, the provisions of section 333 (a) (6) apply and accordingly A must be considered the constructive owner of his wife's stock under the option rule rather than the family-partnership rule. B thus becomes the constructive owner of 30 percent of the stock of the M Corporation, namely, his own 10 percent, A's 10 percent, and AW's 10 percent constructively owned by A as the holder of an option on the stock.

[SEC. 333. *Stock ownership.*]

(*b*) *Convertible securities.*—Outstanding securities convertible into stock (whether or not convertible during the taxable year) shall be considered as outstanding stock—

(1) For the purpose of the stock ownership requirement provided in section 331 (a) (2), but only if the effect of the inclusion of all such securities is to make the corporation a foreign personal holding company;

(2) For the purpose of section 332 (e) (relating to personal service contracts), but only if the effect of the inclusion of all such securities is to make the amounts

therein referred to includible under such subsection as foreign personal holding company income; and

(3) For the purpose of section 332 (f) (relating to the use of property by shareholders), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such subsection as foreign personal holding company income.

The requirement in paragraphs (1), (2), and (3) that all convertible securities must be included if any are to be included shall be subject to the exception that, where some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be included although the others are not included, but no convertible securities shall be included unless all outstanding securities having a prior conversion date are also included.

ART. 333 (b)-1. *Convertible securities.*—Under section 333 (b), outstanding securities of a foreign corporation, such as bonds, debentures, or other corporate obligations, convertible into stock of the corporation (whether or not convertible during the taxable year) shall be considered as outstanding stock of the corporation for the purpose of the stock ownership requirement provided in section 331 (a) (2), but only if the effect of such consideration is to make the corporation a foreign personal holding company. Such convertible securities shall be considered as outstanding stock for the purpose of section 332 (e), relating to amounts received under personal service contracts, or of section 332 (f), relating to compensation for the use of property, but only if the effect of such consideration is to make the amounts therein referred to includible under such sections as foreign personal holding company income. The consideration of convertible securities as outstanding stock is subject to the exception that, if some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be considered as outstanding stock although the others are not so considered, but no convertible securities shall be considered as outstanding stock unless all outstanding securities having a prior conversion date are also so considered. For example, if outstanding securities are convertible in 1938, 1939, and 1940, those convertible in 1938 can be properly considered as outstanding stock without so considering those convertible in 1939 or 1940, and those convertible in 1938 and 1939 can be properly considered as outstanding stock without so considering those convertible in 1940. However, the securities convertible in 1939 could not be properly considered as outstanding stock without so considering those convertible in 1938 and the securities convertible in 1940 could not be properly considered as outstanding stock without so considering those convertible in 1938 and 1939.

SEC. 334. *Gross income of foreign personal holding companies.*—(a) *General rule.*—As used in this Supplement with respect to a foreign corporation the term "gross income" means gross income computed (without regard to the provisions of Supplement I) as if the foreign corporation were a domestic corporation.

(b) *Additions to gross income.*—In the case of a foreign personal holding company (whether or not a United States group, as defined in section 331 (a) (2), existed with respect to such company on the last day of its taxable year) which was a shareholder in another foreign personal holding company on the day in the taxable year (whether beginning before, on or after January 1, 1938) of the second company which was the last day on which a United States group existed with respect to the second company, there shall be included, as a dividend, in the gross income of the first company, for the taxable year in which or with which the taxable year of the second company ends, the amount the first company would have received as a dividend if on such last day there had been distributed by the second company, and received by the shareholders, an amount which bears the same ratio to the undistributed Supplement P net income of the second company for its taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.

(c) *Application of subsection* (b).—The rule provided in subsection (b)—

(1) shall be applied in the case of a foreign personal holding company for the purpose of determining its undistributed Supplement P net income which, or a part of which, is to be included in the gross income of its shareholders, whether United States shareholders or other foreign personal holding companies;

(2) shall be applied in the case of every foreign corporation with respect to which a United States group exists on some day of its taxable year, for the purpose of determining whether such corporation meets the gross income requirements of section 331 (a) (1).

ART. 334-1. *Gross income in general for purposes of Supplement P.*—For all purposes of Supplement P and Chapter XXXIV of these regulations, the gross income of a foreign corporation shall be computed as if the corporation were a domestic corporation and without regard to the provisions of Supplement I and Chapter XXVII of these regulations, relating to the taxation of foreign corporations generally. Hence, for such purposes, the gross income includes income from all sources, whether within or without the United States, which is not excluded from gross income by section 22 (b) and the regulations pertaining to that section. The gross income thus includes the interest on bonds, notes, and certificates of indebtedness of the United States, even though owned beneficially by a foreign corporation not engaged in trade or business in the United States, and even though such interest otherwise would come within the exemption provided for in section 3 of the Fourth Liberty Bond Act of July 9, 1918, as amended by section 4 of the Victory Liberty Loan Act of March 3, 1919.

ART. 334-2. *Additions to gross income for purposes of Supplement P.*—If, for any taxable year—

(a) a foreign corporation meets the stock ownership requirement specified in article 331-3, regardless of whatever day in its taxable year is the last day on which the required United States group exists, and

(b) such foreign corporation is a shareholder in a foreign personal holding company on any day of a taxable year (whether beginning before, on or after January 1, 1938) of the second company which ends with or within the taxable year of the first company and such day is the last day in the taxable year of the second company on which the United States group exists with respect to the second company,

then for the purpose of—

(c) determining whether the first company meets the gross income requirement specified in article 331-2, so as to come within the classification of a foreign personal holding company, and

(d) determining the undistributed Supplement P net income of the first company which (in the event the first company is a foreign personal holding company) is to be included, in whole or in part, in the gross income of its shareholders, whether United States shareholders or other foreign personal holding companies.

there shall be included as a dividend in the gross income of the first company for the taxable year in which or with which the taxable year of the second company ends, the amount the first company would have received as a dividend, if on the last day referred to in (b) there had been distributed by the second company, and received by the shareholders, an amount which bears the same ratio to the undistributed Supplement P net income of the second company for its taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year. The foregoing rules apply to any chain of foreign corporations regardless of the number of corporations included in the chain.

The application of this article may be illustrated by the following examples:

Example (1): The X Corporation is a foreign corporation whose stock is owned by A, a United States citizen. The X Corporation owns the entire stock of the Y Corporation, another foreign corporation. The taxable year of the X Corporation is the calendar year and the taxable year of the Y Corporation is the fiscal year ending June 30. For the fiscal year ending June 30, 1939, more than the required percentage of the Y Corporation's gross income consists of foreign personal holding company income and no part of the earnings for such year is distributed as dividends. On the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1939. The X Corporation meets the stock ownership requirement and constitutes a foreign personal holding company for 1939, if it also meets the gross income requirement.

For the purpose of determining whether the X Corporation meets the gross income requirement, the entire undistributed Supplement P net income of the Y Corporation for the fiscal year ending June 30, 1939, must be included as a dividend in the gross income of the X Corporation for 1939, since—

(a) the X Corporation was a shareholder in the Y Corporation on a day (June 30, 1939) in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation, which day was the last day in the taxable year of the Y Corporation on which the United States group required with respect to the Y Corporation existed,

(b) such last day was also the end of the Y Corporation's taxable year so that the portion of the taxable year of the Y Corporation up to and including such last day is equal to 100 percent of the taxable year of the Y Corporation, and, therefore, the portion of the undistributed Supplement P net income of the Y Corporation includible in the gross income of its shareholders is likewise equal to 100 percent, and

(c) The X Corporation being the sole shareholder of the Y Corporation must include such portion in its gross income for 1939, the taxable year in which or with which the taxable year of the Y Corporation ends.

If, after the inclusion of the presumptive dividend in its gross income, the X Corporation is a foreign personal holding company for 1939, then the undistributed Supplement P net income of the Y Corporation must also be included as a dividend in the gross income of the X Corporation in determining its undistributed Supplement P net income which is to be included in the gross income of A, the sole shareholder in the X Corporation. On the other hand, if, after including such presumptive dividend, the X Corporation does not constitute a foreign personal holding company, the undistributed Supplement P net income of the Y Corporation is not includible in the gross income of the X Corporation.

Example (2): The X Corporation referred to in example (1) sold the stock in the Y Corporation to other interests on September 30, 1939, so that after that date no United States group existed with respect to the Y Corporation. For the fiscal year ending June 30, 1940, more than the required percentage of the gross income of the Y Corporation consists of foreign personal holding company income. The net income of the Y Corporation for such fiscal year amounts to $1,000,000, of which $900,000 is distributed in dividends after September 30, 1939. The undistributed Supplement P net income of the Y Corporation for such fiscal year amounts to $100,000. Upon the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1940, since at one time in such fiscal year, or from July 1 to and including September 30, 1939, it meets the stock ownership requirement, and the gross income requirement is also satisfied.

In determining whether the X Corporation constitutes a foreign personal holding company for 1940, a portion of the undistributed Supplement P net income of the Y Corporation for the fiscal year ending June 30, 1940 (3/12 of $100,000, or $25,000), must be included as a dividend in the gross income of the X Corporation, since—

(a) the X Corporation was a shareholder in the Y Corporation on September 30, 1939, or on a day in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation which day was the last day in the Y Corporation's taxable year on which the United States group required with respect to the Y Corporation existed.

(b) The portion of the taxable year of the Y Corporation up to and including such day is three-twelfths of the entire taxable year of the Y Corporation and, therefore, the portion of the undistributed Supplement P net income of the Y Corporation includible in the gross income of its shareholders also is equal to three-twelfths, and

(c) the X Corporation, being the sole shareholder of the Y Corporation at the time the United States group with respect to the Y Corporation last existed, must include all of such portion in its gross income for 1940, the taxable year of the X Corporation in which or with which the taxable year of the Y Corporation ends.

It is to be observed that three-twelfths of the undistributed Supplement P net income of the Y Corporation for the entire taxable year and not the earnings realized by the Y Corporation up to and including September 30, 1939, the last day on which the United States group with respect to the Y Corporation existed, must be included in the gross income of the X Corporation.

Example (3): The X Corporation referred to in example (1) sold the stock in the Y Corporation to other interests on September 30, 1939, so that after that date a different United States group existed with respect to the Y Corporation. Assuming that the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1940, no part of the undistributed Supplement P net income of the Y Corporation for such fiscal year would, in this instance, be includible in the gross income of the X Corporation for the year 1940, in determining whether the X Corporation is a foreign personal holding company for that year. In such case, the undistributed Supplement P net income of the Y Corporation is includible in the gross income of the other foreign personal holding companies, if any, and of the United States shareholders who are shareholders in the Y Corporation the day after September 30, 1939, which was the last day in the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation existed.

If, however, the X Corporation sells 90 percent of its stock in the Y Corporation and thus is a minority shareholder in the Y Corporation on the last day of the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation exists, the portion of the undistributed Supplement P net income allocable to the minority interest of the X Corporation would be includible in the gross income of the X Corporation, even though on such last day the United States group is not the same with respect to both corporations.

Example (4): If the Y Corporation in example (1) owns all of the stock of the Z Corporation, another foreign corporation, there would be a chain of three foreign corporations. In such case, assuming that the Z Corporation is a foreign personal holding company for a taxable year ending with or within the taxable year of the Y Corporation, the undistributed Supplement P net income of the Z Corporation would be included in the gross income of the Y Corporation for the purpose of determining whether the Y Corporation comes within the classification of a foreign personal holding company. If, after the inclusion of such presumptive dividend, the Y Corporation is a foreign personal holding company, the undistributed Supplement P net income of the Z Corporation would be included in the gross income of the Y Corporation in determining the undistributed Supplement P net income of the Y Corporation which is includible in the gross income of its shareholder, the X Corporation. The same process would be repeated with respect to determining whether the X Corporation is a foreign personal holding company and in determining its undistributed Supplement P net income. If all three corporations are foreign personal holding companies, the undistributed Supplement P net income of each would, in this manner, be reflected as a dividend in the gross income of A, the ultimate beneficial shareholder of the chain.

In the event that after the inclusion of the undistributed Supplement P net income of the Z Corporation in the gross income of the Y Corporation, the Y Corporation is not a foreign personal holding Company, then no part of the income of either the Z Corporation or the Y Corporation would be includible in the gross income of the X Corporation. In that event, whether the X Corporation is a foreign personal holding company, and its undistributed Supplement P net income, would be determined independently of the income of the Y Corporation and the Z Corporation.

SEC. 335. *Undistributed supplement P net income.*—For the purposes of this title the term "undistributed Supplement P net income" means the Supplement P net income (as defined in section 336) minus the amount of the basic surtax credit provided in section 27 (b) (computed without is reduction, under section 27 (b) (1), by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations).

SEC. 336. *Supplement P net income.*—For the purposes of this title the term "Supplement P net income" means the net income with the following adjustments:

(a) *Additional deductions.*—There shall be allowed as deductions—

(1) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction under section 23; but not including the tax imposed by section 102, section 401, or a section of a prior income-tax law corresponding to either of such sections.

(2) In lieu of the deduction allowed by section 23 (q), contributions or gifts payment of which is made within the taxable year to or for the use of donees described in section 23 (q) for the purposes therein specified, to an amount which does not exceed 15 per centum of the company's net income, computed without the benefit of this paragraph and section 23 (q), and without the deduction of the amount disallowed under subsection (b) of this section, and without the inclusion in gross income of the amounts includible therein as dividends by reason of the application of the provisions of section 334 (b) (relating to the inclusion in the gross income of a foreign personal holding company of its distributive share of the undistributed Supplement P net income of another foreign personal holding company in which it is a shareholder).

(b) *Deductions not allowed.*—(1) *Taxes and pension trusts.*—The deductions provided in section 23 (d), relating to taxes of a shareholder paid by the corporation, and in section 23 (p), relating to pension trusts, shall not be allowed.

(2) *Expenses and depreciation.*—The aggregate of the deductions allowed under section 23 (a), relating to expenses, and section 23 (l), relating to depreciation, which are allocable to the operation and maintenance of property owned or operated by the company, shall be allowed only in an amount equal to the rent or other compensation received for the use or right to use the property, unless it is established (under regulations prescribed by the Commissioner with the approval of the Secretary) to the satisfaction of the Commissioner:

(A) That the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

(B) That the property was held in the course of a business carried on bona fide for profit; and

(C) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

ART. 336-1. *Supplement P net income.*—The term "Supplement P net income" means the gross income as defined in section 334 less the deductions provided in section 23 (computed without regard to the provisions of Supplement I), subject to the qualifications, limitations, and exceptions provided in section 336. In addition to the qualifications, limitations, and exceptions provided in section 336 (a) and section 336 (b) (1), under section 336 (b) (2) the aggregate of the deductions allowed under section 23 (a), relating to expenses, and section 23 (l), relating to depreciation, which are allocable to the operation and maintenance of property owned or operated by the company shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner:

(1) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(2) That the property was held in the course of a business carried on bona fide for profit; and

(3) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If a United States shareholder, in computing his distributive share of the undistributed Supplement P net income of a foreign personal holding company to be included in gross income in his individual return (see section 337 and article 337-1), claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, he shall attach to his income tax return a statement setting forth his claim for allowance of the additional deductions together with a complete statement of the facts and circumstances pertinent to his claim and the arguments on which he relies. Such statement shall set forth:

(a) A description of the property;

(b) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(c) The name and address of the person from whom acquired and the date thereof;

(d) The name and address of the person to whom leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(e) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years:

(f) Evidence that the rent or other compensation was the highest obtainable and, if none was received, a statement of the reasons therefor;

(g) A copy of the contract, lease or rental agreement;

(h) The purpose for which the property was used;

(i) The business carried on by the corporation with respect to which the property was held and the gross income, expenses and net income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(j) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(k) Any other information pertinent to the taxpayer's claim.

ART. 336-2. *Illustration of computation of Supplement P net income and undistributed Supplement P net income.*—The method of computation of the Supplement P net income and undistributed Supplement P net income may be illustrated as follows:

The following facts exist with respect to the M Corporation, a foreign personal holding company, for the calendar year 1938:

The gross income of the corporation as defined in section 334 amounts to $300,000, of which $85,000 represents its distributive share of the undistributed Supplement P net income of another foreign personal holding company in which it is a shareholder, $200,000 consists of dividends, $10,000 consists of interest, and the remainder ($5,000) consists of rent received from the principal shareholder of the corporation for the use of property owned by the corporation.

The expenses of the corporation amount to $83,000, of which $75,000 is allocable to the maintenance and operation of the property used by the principal shareholder, and $8,000 consists of ordinary and necessary office expenses allowable as a deduction. The claim for deduction for the expenses of, and depreciation on, the rented property in excess of the rent received for its use is not established as provided in section 336 (b) (2). The yearly depreciation on the rented property amounts to $30,000.

Federal income tax withheld at the source on the income of the corporation from sources within the United States amounts to $22,250.

No gain from the sale or exchange of stock or securities is realized during the taxable year, but losses in the amount of $10,000 are sustained from the sale of stock or securities which constitute capital assets.

Contributions payment of which is made to or for the use of donees described in section 23 (q), for the purposes therein specified, amount to $15,000, of which $5,000 is deductible in computing net income under section 21.

Dividends paid by the corporation to its shareholders during the taxable year amount to $50,000.

The net income for the purposes of computing the Supplement P net income of the corporation (including the distributive share of the undistributed Supplement P net income of the other foreign personal holding company) is $180,000, computed as follows (assuming for the purposes of this example only that the expenses of, and depreciation on, the rented property are deductible under section 23):

Income (Section 22)

Dividends		$200,000
Interest		10,000
Rent		5,000
Gross income as defined in section 22		215,000
Add:		
Distributive share of undistributed Supplement P net income of the other foreign personal holding company (considered as a dividend)		85,000
Gross income as defined in section 334		300,000

Deductions (Section 23)

Expenses allocable to operation of the rented property	$75,000	
Depreciation of the rented property	30,000	
Ordinary and necessary expenses (office)	8,000	
Losses (limited as provided in section 117)	2,000	
Contributions (within the 5 percent limitation specified in section 23 (q))	5,000	
		120,000
Net income for purposes of computing Supplement P net income		180,000

The Supplement P net income and the undistributed Supplement P net income of the corporation are $247,750 and $197,750, respectively, computed as follows:

Net income for purposes of computing Supplement P net income			$180,000
Add (see section 336 (b)):			
Contributions deductible in computing net income under section 21		$5,000	
Excess property expenses and depreciation over amount of rent received for use of property ($105,000—$5,000)		100,000	
		105,000	
Deduct (see section 336 (a)):			
Federal income taxes	$22,250		
Contributions (within the 15 percent limitation specified in section 336 (a) (2))	15,000		
		37,250	
Net additions under section 336			67,750
Supplement P net income			247,750
Less:			
Basic surtax credit for dividends paid (see section 335)			50,000
Undistributed Supplement P net income			197,750

SEC. 337. *Corporation income taxed to United States shareholders.*—(a) *General rule.*—The undistributed Supplement P net income of a foreign personal holding company shall be included in the gross income of the citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts (other than estates or trusts the gross income of which under this title includes only income from sources within the United States), who are shareholders in such foreign personal holding company (hereinafter called "United States shareholders") in the manner and to the extent set forth in this Supplement.

(b) *Amount included in gross income.*—Each United States shareholder, who was a shareholder on the day in the taxable year of the company which was the last day on which a United States group (as defined in section 331 (a) (2)) existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends, the amount he would have received as a dividend if on such last day there had been distributed by the company, and received by the shareholders, an amount which bears the same ratio to the undistributed Supplement P net income of the company for the taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.

(c) *Credit for obligations of United States and its instrumentalities.*—Each United States shareholder shall be allowed a credit against net income, for the purpose of the tax imposed by sections 11, 13, 14, 201, 204, 207, or 362, of his proportionate share of the interest specified in section 25 (a) (1) or (2) which is included in the gross income of the company otherwise than by the application of the provisions of section 334 (b) (relating to the inclusion in the gross income of a foreign personal holding company of its distributive share of the undistributed Supplement P net income of another foreign personal holding company in which it is a shareholder).

(d) *Information in return.*—Every United States shareholder who is required under subsection (b) to include in his gross income any amount with respect to the undistributed Supplement P net income of a foreign personal holding company and who, on the last day on which a United States group existed with respect to the company, owned 5 per centum or more in value of the outstanding stock of such company shall set forth in his return in complete detail the gross income, deductions and credits, net income, Supplement P net income, and undistributed Supplement P net income of such company.

(e) *Effect on capital account of foreign personal holding company.*—An amount which bears the same ratio to the undistributed Supplement P net income of the foreign personal holding company for its taxable year as the portion of such taxable year up to and including the last day on which a United States group existed with respect to the company bears to the entire taxable year, shall, for the purpose of determining the effect of distributions in subsequent taxable years by the corporation, be considered as paid-in surplus or as a contribution to capital and the accumulated earnings and profits as of the close of the taxable year shall be correspondingly reduced, if such amount or any portion thereof is required to be included as a dividend, directly or indirectly, in the gross income of United States shareholders.

(*f*) Basis of stock in hands of shareholders.—The amount required to be included in the gross income of a United States shareholder under subsection (b) shall, for the purpose of adjusting the basis of his stock with respect to which the distribution would have been made (if it had been made), be treated as having been reinvested by the shareholder as a contribution to the capital of the corporation; but only to the extent to which such amount is included in his gross income in his return, increased or decreased by any adjustment of such amount in the last determination of the shareholder's tax liability, made before the expiration of seven years after the date prescribed by law for filing the return.

(*g*) *Basis of stock in case of death.*—For basis of stock or securities in a foreign personal holding company acquired from a decedent, see section 113 (a) (5).

(*h*) *Liquidation.*—For amount of gain taken into account on liquidation of foreign personal holding company, see section 115 (c).

(*i*) *Period of limitation on assessment and collection.*—For period of limitation on assessment and collection without assessment, in case of failure to include in gross income the amount properly includible therein under subsection (b), see section 275 (d).

ART. 337-1. *Income of foreign personal holding companies taxed to United States shareholders*—(*a*) *General rule.*—Supplement P does not impose a tax on foreign personal holding companies. The undistributed Supplement P net income of such companies, however, must be included in the manner and to the extent set forth in this article, in the gross income of their "United States shareholders," that is, the shareholders who are individual citizens or residents of the United States, domestic corporations, domestic partnerships (see section 901 (a)), and estates or trusts other than estates or trusts the gross income of which under Title I includes only income from sources within the United States.

(*b*) *Amount includible in gross income.*—Each United States shareholder, who was a shareholder on the day in the taxable year of the foreign personal holding company which was the last day on which a United States group (see section 331 (a) (2) and article 331-3) existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends, the amount he would have received as a dividend if on such last day there had been distributed by the company and received by the shareholders an amount which bears the same ratio to the undistributed Supplement P net income of the company for the taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.

The undistributed Supplement P net income of the foreign personal holding company is includible only in the gross income of the United States shareholders who were shareholders in the company on the last day of its taxable year on which the United States group existed with respect to the company. Such United States shareholders, accordingly, are determined by the stock holdings as of such specified time. This rule applies to every United States shareholder who was a shareholder in the company at the specified time regardless of whether the United States shareholder is included within the United States group. For example, a domestic corporation which is a United States shareholder at the specified time must return its distributive share in the undistributed Supplement P net income even though the domestic corporation can not be included within the United States group since, under section 333 (a) (1) and article 333 (a)-2, the stock it owns in the foreign corporation is considered as being owned proportionately by its shareholders for the purpose of determining whether the foreign corporation is a foreign personal holding company.

The United States shareholders must include in their gross income their distributive shares of that proportion of the undistributed Supplement P net income for the taxable year of the company which is equal in ratio to that which the portion of the taxable year up to and including the last day on which the United States group with respect to the company existed bears to the entire taxable year. Thus, if the last day in the taxable year on which the required United States group existed was also the end of the taxable year, the portion of the taxable year up to and including such last day would be equal to 100 per cent and in such case, the United States shareholders would be required to return their distributive shares in the entire undistributed Supplement P net income. But if the last day on which the required United States group existed was September 30, and the taxable year was a calendar year, the portion of the taxable year up to and including such last day would be equal to nine-twelfths and in that case, the United States shareholders would be required to return their distributive shares in only nine-twelfths of the undistributed Supplement P net income.

The amount which each United States shareholder must return is that amount which he would have received as a dividend if the above specified portion of the undistributed Supplement P net income had in fact been distributed by the foreign personal holding company as a dividend on the last day of its taxable year on which the required United States group existed. Such amount is determined, therefore, by the interest of the United States shareholder in the foreign personal holding company, that is, by the number of shares of stock owned by the United States shareholder and the relative rights of his class of stock, if there are several classes of stock outstanding. Thus, if a foreign personal holding company has both common and preferred stock outstanding and the preferred shareholders are entitled to a specified dividend before any distribution may be made to the common shareholders, then the assumed distribution of the stated portion of the undistributed Supplement P net income must first be treated as a payment of the specified dividend on the preferred stock before any part may be allocated as a dividend on the common stock.

The assumed distribution of the required portion of the undistributed Supplement P net income must be returned as dividend income by the United States shareholders for their respective taxable years in which or with which the taxable year of the foreign personal holding company ends. For example, if the M Corporation whose taxable year is the calendar year is a foreign personal holding company for 1938, and if A, one of its United States shareholders, makes returns on a calendar year basis, while B, another United States shareholder, makes returns on the basis of a fiscal year ending November 30, A must return his assumed dividend as income for the taxable year 1938, and B must return his distributive share as income for the fiscal year ending November 30, 1939. In applying this rule, the date as of which the United States group last existed with respect to the company is immaterial. Thus, in the foregoing example, if September 30, 1938, was the last day on which the United States group with respect to the M Corporation existed, B would still be required to return his assumed dividend as income for the fiscal year ending November 30, 1939, even though September 30, 1938, the date as of which the distribution is assumed to have been made, does not fall within such fiscal year.

ART. 337–2. *Credit for obligations of the United States.*—Each United States shareholder required to return his distributive share in the undistributed Supplement P net income of a foreign personal holding company for any taxable year is allowed, for purposes of the tax imposed by sections 11, 13, 14, 201, 204, 207, or 362, a credit against his net income for his proportionate share of whatever interest on obligations of the United States or its instrumentalities (as specified in section 25 (a) (1) and (2)) may be included in the gross income of the company for such taxable year, with the exception of any such interest as may be so included by reason of the application of the provisions of section 334 (b) and article 334–2.

For example, the M Corporation is a foreign personal holding company which owns all the stock of the N Corporation, another foreign personal holding company. Both companies receive interest on obligations of the United States or its instrumentalities as specified in section 25 (a) (1) and (2). In applying the credit allowable under section 337 (c), the United States shareholders of the M Corporation would be entitled to a credit only for their proportionate shares of the interest received by that company and not for any part of the interest received by the N Corporation, regardless of whether the interest received by the N Corporation is included in the gross income of the M Corporation, as an actual dividend or as a constructive dividend under section 334 (b).

ART. 337–3. *Information in return.*—The information required by section 337 (d) in the returns of certain United States shareholders relates only to the taxable year of a foreign personal holding company for which is computed such corporation's undistributed Supplement P net income, all or part of which must be included in gross income by the United States shareholder of whom the information is required. The information shall be submitted as a part of the income tax returns required by the Act of such persons, in the form of a statement attached to the return.

ART. 337–4. *Effect on capital account of foreign personal holding company and basis of stock in hands of shareholders.*—Sections 337 (e) and 337 (f) are designed to prevent double taxation with respect to the undistributed Supplement P net income of foreign personal holding companies. The application of these sections may be illustrated by the following examples:

Example (1): The M Corporation is a foreign personal holding company. Seventy-five percent in value of its capital stock is owned by A, a citizen of the United States, and the remainder, or 25 per cent, of its stock is owned by B, a nonresident alien individual. For the calendar year 1938 the M Corporation has an undistributed Supplement P net income of $100,000. A is required to include $75,000 of such income in gross income in his return for the calendar year 1938. The $100,000 is treated as paid-in surplus or as a contribution to the capital of the M Corporation and its accumulated earnings and profits as of the close of the calendar year 1938 are correspondingly reduced. If after treating such $100,000 as paid-in surplus or as a contribution to capital, the M Corporation has no accumulated earnings and profits at the close of 1938, and if for the calendar year 1939, the M Corporation had no earnings and profits, but distributed $100,000, the amount so distributed would be tax-free in the hands of both A and B. If, however, after treating the $100,000 as paid-in surplus or as a contribution to capital, the M Corporation had accumulated earnings and profits of $100,000 at the close of 1938, the facts otherwise being the same, the distributions in 1939 would be taxable to A, and the taxability of such distributions to B would depend upon the application of section 119 (a) (2) (B), relating to the treatment of dividends from a foreign corporation as income from sources within or without the United States.

Example (2): In example (1) assume the basis of A's stock to be $300,000. If A includes in gross income in his return for the calendar year 1938, $75,000 as a constructive dividend from the M Corporation, the basis of his stock would be $375,000. After the $75,000 is distributed by the M Corporation tax-free the basis of A's stock, assuming no other changes, would again be $300,000. If A failed to include the $75,000 in gross income in his return as required by the Act and his failure was not discovered until after the 7-year period of limitations had expired, the application of the rule would not increase the basis of A's stock. The subsequent tax-free distribution of

$75,000 would reduce his basis to $225,000, thus tending to compensate for his failure to include the amount of $75,000 in his gross income. If the undistributed Supplement P net income of the M Corporation is readjusted within the statutory period of limitations, thus increasing or decreasing the amount A would have to include in his gross income, proper adjustment is required to be made to the basis of A's stock on account of such readjustment.

SEC. 338. *Information returns by officers and directors.*—(a) *Monthly returns.*—On the fifteenth day of each month which begins after the date of the enactment of this Act each individual who on such day is an officer or a director of a foreign corporation which, with respect to its taxable year (if not beginning before August 26, 1936) preceding the taxable year (whether beginning on, before, or after January 1, 1938) in which such month occurs, was a foreign personal holding company, shall file with the Commissioner a return setting forth with respect to the preceding calendar month the name and address of each shareholder, the class and number of shares held by each, together with any changes in stockholdings during such period, the name and address of any holder of securities convertible into stock of such corporation, and such other information with respect to the stock and securities of the corporation as the Commissioner with the approval of the Secretary shall by regulations prescribe as necessary for carrying out the provisions of this Act. The Commissioner, with the approval of the Secretary, may by regulations prescribe, as the period with respect to which returns shall be filed, a longer period than a month. In such case the returns shall be due on the fifteenth day of the succeeding period, and shall be filed by the individuals who on such day are officers and directors of the corporation.

(b) *Annual returns.*—On the sixtieth day after the close of the taxable year of a foreign personal holding company each individual who on such sixtieth day is an officer or director of the corporation shall file with the Commissioner a return setting forth—

(1) In complete detail the gross income, deductions and credits, net income, Supplement P net income, and undistributed Supplement P net income of such foreign personal holding company for such taxable year; and

(2) The same information with respect to such taxable year as is required in subsection (a); except that if all the required returns with respect to such year have been filed under subsection (a) no information under this paragraph need be set forth in the return filed under this subsection.

ART. 338-1. *Information returns by officers and directors of certain foreign corporations*—(a) *Requirement for filing returns*—(1) *General.*—Under section 338 (a), on the 15th day of each month which begins after May 28, 1938, each individual who on such 15th day is an officer or a director of a foreign corporation which, with respect to its taxable year (if not beginning before August 26, 1936) preceding the taxable year (whether beginning on, before, or after January 1, 1938) in which such month occurs, was a foreign personal holding company, is required to file with the Commissioner a monthly information return as provided in that section and this article.

(2) *Returns for a period exceeding one month.*—In the case of a foreign personal holding company, which before the close of its taxable year specified in paragraph (*a*) (1) of this article and ending on or after May 31, 1938, distributed to its shareholders 90 percent or more of its Supplement P net income as defined in Supplement P, added to the Revenue Act of 1936 by section 201 of Title II of the Revenue Act of 1937 or in Supplement P of the Revenue Act of 1938, or which has no such net income for such taxable year, the following periods are prescribed with respect to which information returns on Form 957 shall be filed during the following year:

The return for the last month of the preceding taxable year shall be filed on the 15th day of the first month following the close of such taxable year. Subsequent returns shall be filed for each 6-month period following the close of such taxable year and shall be filed on the 15th day of the first month following such period. If any change in the stock holdings or in the holdings of securities convertible into stock of the corporation occurs during such periods or if a resolution or plan (including any amendments thereof or supplements thereto) for the dissolution of the corporation or for the liquidation of the whole or any part of its capital stock is adopted during such periods, a monthly information return must also be filed on the 15th day of the month following each month in which the change occurs or the resolution or plan is adopted. In any case under this paragraph where the date for filing a monthly return coincides with the date for filing the return for a 6-month period only the return for the 6-month period need be filed.

In the case of a foreign personal holding company which before the close of its taxable year specified in paragraph (*a*) (1) of this article and ended before May 31, 1938, distributed to its shareholders 90 percent or more of its Supplement P net income as defined in Supplement P, added to the Revenue Act of 1936 by section 201 of Title II of the Revenue Act of 1937, or which had no such net income for such taxable year, the following periods are prescribed with respect to which information returns under section 338 (a) of the Revenue Act of 1938 and this article shall be filed during the year following the year for which it had no such net income or in which such distribution occurred and after May 28, 1938:

The first information return shall be filed on the same day an information return would have been required to be filed under section 338 (a) of Supplement P, added to the Revenue Act of 1936 by section 201 of Title II of the Revenue Act of 1937, and paragraph (*a*) (2) of article 338-1 of Chapter XXXIV added to Regulations 94 by Treasury Decision 4782, approved December 7, 1937 (C. B. 1937-2, 168), had the Revenue Act of 1938 not been enacted. Subsequent returns shall be filed for each 6-month period following the close of the month preceding the month in which such day occurs and shall be filed on the 15th day of the first month following such 6-month period. If any change in the stock holdings or in the holdings of securities convertible into stock of the corporation occurs during such periods or if a resolution or plan (including any amendments thereof or supplements thereto) for the dissolution of the corporation or for the liquidation of the whole or any part of its capital stock is adopted during such periods, a monthly information return must be filed on the 15th day of the month following each month in which the change occurs or the resolution or plan is adopted. In any case under this paragraph where the date for filing a monthly return coincides with the date for filing a return for a 6-month period, only the return for the 6-month period need be filed.

(3) *Returns jointly made.*—If two or more officers or directors of a foreign corporation are required to file information returns for any period under section 338 (a) and this article, any two or more of such officers or directors may, in lieu of filing separate returns for such period, jointly execute and file one return.

(*b*) *Form of return.*—The return under section 338 (a) and this article shall be made on Form 957, copies of which, upon request, may be procured from any collector. Each officer or director should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the Act.

(*c*) *Contents of return.*—The return shall, in accordance with the provisions of this article and the instructions on the form, set forth with respect to the preceding period the following information:

(1) Name and address of corporation;

(2) Kind of business in which the corporation is engaged;

(3) Date of incorporation;

(4) The country under the laws of which the corporation is incorporated;

(5) Number of shares and par value of common stock of the corporation outstanding as of the beginning and end of the period;

(6) Number of shares and par value of preferred stock of the corporation outstanding as of the beginning and end of the period, the rate of dividend on such stock and whether such dividend is cumulative or noncumulative;

(7) A description of the convertible securities issued by the corporation, including a statement of the face value of, and rate of interest on, such securities;

(8) The name and address of each shareholder, the class and number of shares held by each, together with any changes in stock holdings during such period;

(9) The name and address of each holder of securities convertible into stock of the corporation, the class, number, and face value of the securities held

by each, together with any changes in the holdings of such securities during the period;

(10) A certified copy of any resolution or plan, and any amendments thereof or supplements thereto, for or in respect of the dissolution of the corporation or the liquidation of the whole or any part of its capital stock; and

(11) Such other information as may be required by the return form.

If a person is required to file a return under section 338 (a) and this article with respect to more than one foreign corporation, a separate return must be filed with respect to each foreign corporation.

(*d*) *Verification of returns.*—All returns required by section 338 (a) and this article shall be verified under oath or affirmation in the same manner as prescribed in article 51-4.

(*e*) *Penalties.*—For criminal penalties for failure to file the returns required by section 338 (a) and this article, see section 340.

ART. 338-2. *Annual information returns by officers and directors of certain foreign corporations*—(a) *Requirement for filing returns*—(1) *General.*—Under section 338 (b), on the sixtieth day after the close of the taxable year of a foreign personal holding company each individual who on such sixtieth day is an officer or director of the corporation shall file with the Commissioner an annual information return as provided in that section and this article.

(2) *Returns jointly made.*—If two or more officers or directors of a foreign corporation are required to file annual information returns under section 338 (b) and this article for any taxable year of the corporation, any two or more of such officers or directors may in lieu of filing separate annual returns for such taxable year, jointly execute and file one annual return.

(*b*) *Form of return.*—The return under section 338 (b) and this article shall be made on Form 958, copies of which, upon request, may be procured from any collector. Each officer or director should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the Act.

(*c*) *Contents of return.*—The return shall, in accordance with the provisions of this article and the instructions on the form, set forth with respect to the taxable year of the foreign personal holding company the following information:

(1) The gross income, deductions and credits, net income, Supplement P net income, and undistributed Supplement P net income of the foreign personal holding company for such taxable year, in complete detail;

(2) The same information with respect to such taxable year which is required by section 338 (a) and paragraph (*c*) of article 338-1, except that if all the required returns with respect to such year have been filed under section 338 (a) and article 338-1, no information under section 338 (b) (2) and this paragraph need be set forth in such annual return; and

(3) Such other information as may be required by the return form.

(*d*) *Verification of returns.*—All returns required by section 338 (b) and this article shall be verified under oath or affirmation in the same manner as prescribed in article 51-4.

(*e*) *Penalties.*—For criminal penalties for failure to file the returns required by section 338 (b) and this article, see section 340.

ART. 338-3. *Time and place of filing returns.*—Returns required by section 338 and the regulations thereunder shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, and will be considered filed within the time or times required by law if, within such time or times, such returns are made and placed in the mails in due course, properly addressed and postage paid, provided they are actually received in the office of the Commissioner of Internal Revenue, Washington, D. C., even though received after such time or times.

SEC. 339. *Information returns by shareholders.*—(*a*) *Monthly returns.*—On the fifteenth day of each month which begins after the date of the enactment of this Act each United States shareholder, by or for whom 50 per centum or more in value of the outstanding stock of a foreign corporation is owned directly or indirectly (including in the case of an individual, stock owned by the members of his family as defined in section 333 (a) (2)), if such foreign corporation with respect to its taxable year (if not beginning before August 26, 1936) preceding the taxable year (whether beginning on, before, or after January 1, 1938) in which such month occurs was a foreign personal holding company, shall file with the Commissioner a return setting forth with respect to the preceding calendar month the name and address of each shareholder, the class and number of shares held by each, together with any changes in stockholdings during such period, the name and address of any holder of securities convertible into stock of such corporation, and such other information with respect to the stock and securities of the corporation as the Commissioner with the approval of the Secretary shall by regulations prescribe as necessary for carrying out the provisions of this Act. The Commissioner, with the approval of the Secretary, may by regulations prescribe, as the period with respect to which returns shall be filed, a longer period than a month. In such case the return shall be due on the fifteenth day of the succeeding period, and shall be filed by the persons who on such day are United States shareholders.

(*b*) *Annual returns.*—On the sixtieth day after the close of the taxable year of a foreign personal holding company each United States shareholder by or for whom on such sixtieth day 50 per centum or more in value of the outstanding stock of such company is owned directly or indirectly (including in the case of an individual, stock owned by members of his family as defined in section 333 (a) (2)), shall file with the Commissioner a return setting forth the same information with respect to such taxable year as is required in subsection (a); except that if all the required returns with respect to such year have been filed under subsection (a) no return shall be required under this subsection.

ART. 339-1. *Information returns by shareholders of certain foreign corporations*—(*a*) *Requirement for filing returns*—(1) *General.*—On the 15th day of each month which begins after May 28, 1938, each United States shareholder, by or for whom 50 percent or more in value of the outstanding stock of a foreign corporation is owned, directly or indirectly (including, in the case of an individual, stock owned by members of his family as defined in section 333 (a) (2)), if such foreign corporation with respect to its taxable year (if not beginning before August 26, 1936) preceding the taxable year (whether beginning on, before, or after January 1, 1938) in which such month occurs was a foreign personal holding company, shall file with the Commissioner an information return as provided in section 339 (a) and this article.

(2) *Returns for a period exceeding one month.*—In the case of a foreign personal holding company which before the close of its taxable year specified in paragraph (*a*) (1) of this article, distributed to its shareholders 90 percent or more of its Supplement P net income, or which has no such net income for such taxable year, the periods with respect to which information returns under section 339 (a) shall be filed shall be the same as the periods prescribed in paragraph (*a*) (2) of article 338-1.

(3) *Duplicate returns.*—If a shareholder in a foreign corporation files, as an officer or director in such corporation, the returns required by section 338 (a) and article 338-1 such returns shall be considered as returns filed under section 339 (a).

(*b*) *Form of return.*—The return under section 339 (a) and this article shall be made on Form 957, copies of which, upon request, may be procured from any collector. Each shareholder should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the Act.

(*c*) *Contents of return.*—The return shall, in accordance with the provisions of this article and the instructions on the form, set forth with respect to the preceding period the same information as required to be shown on that form by section 338 (a) and paragraph (*c*) of article 338-1.

If a person is required to file a return under section 339 (a) and this article with respect to more than one foreign corporation, a separate return must be filed with respect to each foreign corporation.

(*d*) *Verification of returns.*—All returns required by section 339 (a) and this article shall be verified under oath or affirmation in the same manner as prescribed in article 51–4.

(*e*) *Penalties.*—For criminal penalties for failure to file the returns required by section 339 (a) and this article, see section 340.

ART. 339–2. *Annual information returns by shareholders of certain foreign corporations*—(*a*) *Requirement for filing returns*—(1) *General.*—Under section 339 (b), on the sixtieth day after the close of the taxable year of a foreign personal holding company, each United States shareholder, by or fo whom on such sixtieth day 50 percent or more in value of the outstanding stock of the company is owned, directly or indirectly (including in the case of an individual, stock owned by members of his family as defined in section 333 (a) (2)), shall file with the Commissioner an information return as provided in that section and this article.

(2) *Duplicate returns.*—If a shareholder in a foreign corporation files, as an officer or director in such corporation, the returns required by section 338 (b) and article 338–2, such returns shall be considered as returns filed under section 339 (b).

(*b*) *Form of return.*—The return under section 339 (b) and this article shall be made on Form 957, copies of which, upon request, may be procured from any collector. Each shareholder should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the Act.

(*c*) *Contents of return.*—The return shall, in accordance with the provisions of this article and the instructions on the form, set forth with respect to the taxable year of the foreign personal holding company the same information which is required under section 339 (a), paragraph (*c*) of article 338–1 and paragraph (*c*) of article 339–1, except that if all the required returns with respect to such year have been filed under section 339 (a) and article 339–1, no return under section 339 (b) and this article is required.

If a person is required to file an annual return under section 339 (b) and this article with respect to more than one foreign personal holding company, a separate return must be filed with respect to each foreign personal holding company.

(*d*) *Verification of returns.*—All returns required by section 339 (b) and this article shall be verified under oath or affirmation in the same manner as prescribed in article 51–4.

(*e*) *Penalties.*—For criminal penalties for failure to file the returns required by section 339 (b) and this article see section 340.

ART. 339–3. *Time and place of filing returns.*—Returns required by section 339 and the regulations thereunder shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, and will be considered filed within the time or times required by law if, within such time or times, such returns are made and placed in the mails in due course, properly addressed and postage paid, provided they are actually received in the office of the Commissioner of Internal Revenue, Washington, D. C., even though received after such time or times.

SEC. 340. *Penalties.*—Any person required under section 338 or 339 to file a return, or to supply any information, who willfully fails to file such return, or supply such information, at the time or times required by law or regulations, shall, in lieu of the penalties provided in section 145 (a) for such offense, be guilty of a misdemeanor and, upon conviction thereof, be fined not more than $2,000, or imprisoned for not more than one year, or both.

CHAPTER XXXV

Mutual Investment Companies

Supplement Q—Mutual Investment Companies

SEC. 361. *Definition.*—(*a*) *In general.*—For the purposes of this title the term "mutual investment company" means any domestic corporation (whether chartered or created as an investment trust, or otherwise), other than a personal holding company as defined in Title IA, if—

(1) It is organized for the purpose of, and substantially all its business consists of, holding, investing, or reinvesting in stock or securities; and

(2) At least 95 per centum of its gross income is derived from dividends, interest, and gains from sales or other disposition of stock or securities; and

(3) Less than 30 per centum of its gross income is derived from the sale or other disposition of stock or securities held for less than six months; and

(4) An amount not less than 90 per centum of its net income is distributed to its shareholders as taxable dividends during the taxable year; and

(5) Its shareholders are, upon reasonable notice, entitled to redemption of their stock for their proportionate interests in the corporation's properties, or the cash equivalent thereof less a discount not in excess of 3 per centum thereof.

(*b*) *Limitations.*—Despite the provisions of paragraph (1) a corporation shall not be considered as a mutual investment company if at any time during the taxable year—

(1) More than 5 per centum of the gross assets of the corporation, taken at cost, was invested in stock or securities, or both, of any one corporation, government, or political subdivision thereof, but this limitation shall not apply to investments in obligations of the United States or in obligations of any corporation organized under general Act of Congress if such corporation is an instrumentality of the United States; or

(2) It owned more than 10 per centum of the outstanding stock or securities, or both, of any one corporation; or

(3) It had any outstanding bonds or indebtedness in excess of 10 per centum of its gross assets taken at cost; or

(4) It fails to comply with any rule or regulation prescribed by the Commissioner, with the approval of the Secretary, for the purpose of ascertaining the actual ownership of its outstanding stock.

ART. 361–1. *Definition of a mutual investment company.*—The term "mutual investment company" means a domestic corporation whether chartered or incorporated, or created under a trust instrument or otherwise, as an investment trust, and whether of the fixed or general management type (other than a personal holding company as defined in section 402), which complies with all the conditions prescribed by section 361. As to definition of a corporation see section 901.

ART. 361–2. *Proof of status of a mutual investment company.*—(*a*) The Act requires that the corporation must have been organized for the purpose of, and that substantially all of its business must have consisted of, holding, investing or reinvesting in, stock or securities. It is not sufficient that the corporation is engaged in holding, investing or reinvesting in, stock or securities. It must have been organized for that purpose, and, throughout the taxable year, operated primarily as a medium through which contributing shareholders are offered centralized management and diversity of investments. If its predominant purpose is to hold, invest or reinvest in, stock or securities, and if substantially all of its business consists of holding, investing or reinvesting in, such stock or securities, the existence or exercise of incidental powers to engage in other business will not deprive a corporation of classification as mutual investment company. A finance corporation, or a corporation engaged in the business of a dealer in stock or securities, or of a trader in stock or securities for its own account, is not a mutual investment company.

(*b*) The Act provides that at least 95 percent of the corporation's gross income for the taxable year must be derived from dividends, interest, and gains from sales or other disposition of stock or securities, and that less than 30 percent of the corporation's gross income for the taxable year must have been derived from the sale or other disposition of stock or securities held for less than six months. (See section 361 (a) (2) and (3).) In determining the percentage of the corporation's gross income which has been derived from such sources, a loss from the sale or other disposition of stock or securities does not enter into the computation. The determination of the period for which stock or securities have been held shall be governed by the provisions of section 117 (h) in so far as applicable.

(*c*) The Act provides that an amount not less than 90 percent of the corporation's net income for the taxable year must have been distributed to its shareholders as taxable dividends during the taxable year. The term "taxable dividends" means dividends (as defined in section 115) which are taxable in the hands of such shareholders as are subject to taxation under Title I, and includes, for the purpose of section 361 (a) (4), the proportionate share of the net earnings of the current year to the date of redemption distributed to the shareholder upon redemption. A taxable dividend is not distributed to its shareholders during the taxable year within the meaning of section 361 (a) (4), unless the dividend is received by the shareholders during the taxable year of the company. See article 27 (b)-2, relating to when dividends are considered paid.

(*d*) The Act requires that shareholders must, upon reasonable notice, be entitled at all times during the taxable year to redemption or purchase of their stock for their proportionate interests in the corporation's properties, or the cash equivalent thereof, less a discount not in excess of 3 percent thereof. Redemption within 60 days of written notice is redemption upon reasonable notice, even though subject to exception in case of extraordinary crises.

ART. 361-3. *Records to be kept for purpose of ascertaining actual ownership of outstanding stock of mutual investment companies.*—Every mutual investment company shall maintain in the collection district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by these regulations to be demanded from the shareholders. The term "actual owner of stock," as used in these regulations, includes the person who is required to include in gross income in his return the dividends received on the stock. Such records shall be kept at all times available for inspection, by any authorized officer or employee of the Bureau of Internal Revenue, and shall be retained as long as the contents thereof may become material in the administration of any internal-revenue law.

A mutual investment company shall demand of each of its shareholders (or in the case of a company all or substantially all of the capital stock of which is held by trustees for the purpose of exercising voting rights, such company shall demand of each of the registered holders of certificates of beneficial interest in the company) on or before the payment of any dividend a written statement giving (1) the name and address of the actual owner, as of the date the shareholder becomes entitled to the dividend, whether payable then or later, of the stock with respect to which the dividend is payable, (2) the name and address of the person who executes the statement, and (3) the number of shares to which the statement pertains, or if the statement is made by the actual owner, the total number of shares actually owned by such person.

At the time the first demand is made as required by this article, a like statement shall be demanded with respect to any prior dividends paid within the taxable year, unless at the time such dividends were paid ownership statements were demanded as required by article 48 (e)-4 of Regulations 94.

ART. 361-4. *Records to be kept for purpose of determining whether a corporation claiming to be a mutual investment company is a personal holding company.*—For the purpose of determining whether a domestic corporation claiming to be a mutual investment company is a personal holding company as defined in section 402, the permanent records of the corporation shall show, to the best of the knowledge and belief of the actual owners of its stock, the maximum number of shares of the corporation (including the number and face value of securities convertible into stock of the corporation) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the corporation's taxable year, as provided in section 404. Statements giving such additional information shall be demanded not later than 30 days after the close of the corporation's taxable year, as follows:

(1) In the case of a corporation having 2,000 or more actual owners of its stock on any dividend payment date, as disclosed by statements received in response to demands made by the corporation as provided in article 361-3, from each person so disclosed or known to the corporation as the actual owner of 5 percent or more of its stock; or

(2) in the case of a corporation having less than 2,000 and more than 200 actual owners of its stock as so disclosed, from each person so disclosed or known to the corporation as actually owning 1 percent or more of its stock; or

(3) in the case of a corporation having 200 or less actual owners of its stock, from each person who is the actual owner of one-half of 1 percent or more of its stock.

ART. 361-5. *Additional information required in returns of shareholders.*—Any person who fails or refuses to comply with the demand of a mutual investment company for the written statements which articles 361-3 and 361-4 require the company to demand from its shareholders shall submit as a part of the income tax return required by the Act of such person a statement showing, to the best of his knowledge and belief—

(1) the number of shares actually owned by him at any and all times during the period for which the return is filed in any company claiming to be a mutual investment company;

(2) the dates of acquisition of any such stock during such period and the names and addresses of persons from whom it was acquired;

(3) the dates of disposition of any such stock during such period and the names and addresses of the transferees thereof;

(4) the names and addresses of the members of his family (as defined in section 404 (a) (2)); the names and addresses of his partners, if any, in any partnership; and the maximum number of shares, if any, actually owned by each in any corporation claiming to be a mutual investment company, at any time during the last half of the taxable year of such company;

(5) the names and addresses of any corporation, partnership, association, or trust in which he had a beneficial interest to the extent of at least 10 percent at any time during the period for which such return is made, and the number of shares of any corporation claiming to be a mutual investment company actually owned by each;

(6) the maximum number of shares (including the number and face value of securities convertible into stock of the corporation) in any domestic corporation claiming to be a mutual investment company to be considered as constructively owned by such individual at any time during the last half of the corporation's taxable year, as provided in section 404 and articles 404 (a)-1 to 404 (a)-7 and article 404 (b)-1; and

(7) the amount and date of receipt of each dividend received during such period from every corporation claiming to be a mutual investment company.

When making demand for the written statements required of each shareholder under these regulations, the company shall inform each of the shareholders of his duty to submit as a part of his income tax return the statements which are required by this article if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with a company's demand shall be maintained as a part of its records required by these regulations. A company which fails to keep such records to show the actual ownership of its outstanding stock as are required by these regulations, or which may be required from time to time by any rule or regulation prescribed by the Commissioner, with the approval of the Secretary, for such purpose, shall not be taxable as a mutual investment company.

Nothing in these regulations shall be construed to relieve mutual investment companies or their shareholders from the duty of filing information returns required by regulations prescribed under sections 147 and 148.

SEC. 362. *Tax on mutual investment companies.*—(*a*) *Supplement Q net income.*—For the purposes of this title the term "Supplement Q net income" means the adjusted net income minus the basic surtax credit computed under section 27 (b) without the application of paragraphs (2) and (3).

(*b*) *Imposition of tax.*—There shall be levied, collected, and paid for each taxable year upon the Supplement Q net income of every mutual investment company a tax equal to 16½ per centum of the amount thereof.

ART. 362-1. *Tax on mutual investment companies.*—If a corporation, as defined in section 901, shows to the satisfaction of the Commissioner that it is entitled to the status of a mutual investment company, as defined in section 361, it is taxable upon its Supplement Q net income, as defined in section 362 (a), at the rate of 16½ percent. A mutual investment company is not allowed, under section 362 (a), the credit for dividends received provided in section 26 (b). In all other respects, a mutual investment company is treated, for purposes of taxation, as any other corporation subject to taxation under the Act.

CHAPTER XXXVI

Exchanges and Distributions in Obedience to Orders of Securities and Exchange Commission

Supplement R—Exchanges and Distributions in Obedience to Orders of Securities and Exchange Commission

SEC. 371. *Nonrecognition of gain or loss*—(*a*) *Exchanges of stock or securities only.*—No gain or loss shall be recognized to the transferor if stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are transferred to such corporation or to an associate company thereof which is a registered holding company or a majority-owned subsidiary company solely in exchange for stock or securities (other than stock or securities which are nonexempt property), and the exchange is made by the transferee corporation in obedience to an order of the Securities and Exchange Commission.

(*b*) *Exchanges of property for property by corporations.*—No gain or loss shall be recognized to a transferor corporation which is a registered holding company or an associate company of a registered holding company, if such corporation, in obedience to an order of the Securities and Exchange Commission transfers property solely in exchange for property (other than nonexempt property), and such order recites that such exchange by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which the transferor corporation is a member.

(*c*) *Distribution of stock or securities only.*—If there is distributed, in obedience to an order of the Securities and Exchange Commission, to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, stock or securities (other than stock or securities which are nonexempt property), without the surrender by such shareholder of stock or securities in such corporation, no gain to the distributee from the receipt of the stock or securities so distributed shall be recognized.

(*d*) *Transfers within system group.*—(1) No gain or loss shall be recognized to a corporation which is a member of a system group (A) if such corporation transfers property to another corporation which is a member of the same system group in exchange for other property, and the exchange by each corporation is made in obedience to an order of the Securities and Exchange Commission, or (B) if there is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, property, without the surrender by such shareholder of stock or securities in the corporation making the distribution, and the distribution is made and received in obedience to an order of the Securities and Exchange Commission. If an exchange by or a distribution to a corportion with respect to which no gain or loss is recognized under any of the provisions of this paragraph may also be considered to be within the provisions of subsection (a), (b), or (c), then the provisions of this paragraph only shall apply.

(2) If the property received upon an exchange which is within any of the provisions of paragraph (1) of this subsection consists in whole or in part of stock or securities issued by the corporation from which such property was received, and if in obedience to an order of the Securities and Exchange Commission such stock or securities (other than stock which is not preferred as to both dividends and assets) are sold and the proceeds derived therefrom are applied in whole or in part in the retirement or cancellation of stock or of securities of the recipient corporation outstanding at the time of such exchange, no gain or loss shall be recognized to the recipient corporation upon the sale of the stock or securities with respect to which such order was made; except that if any part of the proceeds derived from the sale of such stock or securities is not so applied, or if the amount of such proceeds is in excess of the fair market value of such stock or securities at the time of such exchange, the gain, if any, shall be recognized, but in an amount not in excess of the proceeds which are not so applied, or in an amount not more than the amount by which the proceeds derived from such sale exceed such fair market value, whichever is the greater.

(*e*) *Exchanges not solely in kind.*—(1) If an exchange (not within any of the provisions of subsection (d)) would be within the provisions of subsection (a) or (b) if it were not for the fact that property received in exchange consists not only of property permitted by such subsection to be received without the recognition of gain or loss, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property, and the loss, if any, to the recipient shall not be recognized.

(2) If an exchange is within the provisions of paragraph (1) of this subsection and if it includes a distribution which has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under such paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under such paragraph (1) shall be taxed as a gain from the exchange of property.

(*f*) *Application of section.*—The provisions of this section shall not apply to an exchange or distribution unless (1) the order of the Securities and Exchange Commission in obedience to which such exchange or distribution was made recites that such exchange or distribution is necessary or appropriate to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935, (2) such order specifies and itemizes the stock and securities and other property which are ordered to be transferred and received upon such exchange or distribution, and (3) such exchange or distribution was made in obedience to such order and was completed within the time prescribed therefor in such order.

(*g*) *Non-application of other provisions.*—If an exchange or distribution made in obedience to an order of the Securities and Exchange Commission is within any of the provisions of this section and may also be considered to be within any of the provisions of section 112 (other than the provisions of paragraph (8) of subsection (b)), then the provisions of this section only shall apply.

ART. 371–0. *Terms used.*—The following terms are defined in section 373 and when used in this article and articles 371–1 to 373–1 shall have the meanings therein assigned to them: "Order of the Securities and Exchange Commission"; "registered holding company"; "holding-company system"; "associate company"; "majority-owned subsidiary company"; "system group"; "nonexempt property"; and "stock or securities." Any other term used in this article and articles 371–1 to 373–1, which is defined in the Act, shall be given the respective definition contained in the Act.

ART. 371–1. *Purpose and scope of exception.*—The general rule is that the entire amount of gain or loss from the sale or exchange of property is to be recognized (see section 112 (a)) and that the entire amount received as a dividend is to be included in gross income (see sections 22 (a) and 115). Exceptions to the general rule are provided in section 112, one of which is that made by section 112 (b) (8) with respect to exchanges, sales, and distributions specifically described in section 371. Section 371 provides the extent to which gain or loss is not to be recognized on an exchange or sale, or the receipt of a distribution, made in obedience to an order of the Securities and Exchange Commission, which is issued to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935. Section 115 (c) provides that a distribution in liquidation of a corporation shall be treated as an exchange, and such a distribution is to be so treated under the provisions of Supplement R. The order of the Securities and Exchange Commission must be one requiring or approving action which the Commission finds to be necessary or appropriate to effect a simplification or geographical integration of a particular public utility holding-company system. For specific requirements with respect to an order of the Securities and Exchange Commission, see section 371 (f).

The requirements for nonrecognition of gain or loss as provided in section 371 are precisely stated with respect to the following four general types of transactions:

(1) The exchange that is provided for in section 371 (a), in which stock or securities in a registered holding company or a majority-owned subsidiary company are exchanged for stock or securities.

(2) The exchange that is provided for in section 371 (b), in which a registered holding company or an associate company of a registered holding company exchanges property for property.

(3) The distribution that is provided for in section 371 (c), in which stock or securities are distributed to a share holder in a corporation which is a registered holding company or a majority-owned subsidiary company.

(4) The transfer that is provided for in section 371 (d), in which a corporation which is a member of a system group transfers property to another member of the same system group.

Certain rules with respect to the receipt of nonexempt property on an exchange described in section 371 (a) or (b) are prescribed in section 371 (e).

These new exceptions to the general rule are to be strictly construed as in the case of the other exceptions in section 112. Unless both the purpose and the specific requirements of Supplement R are clearly met, the recognition of gain or loss upon the exchange, sale, or distribution will not be postponed under Supplement R. Moreover, even though a taxable transaction occurs in connection or simultaneously with a realization of gain or loss to which nonrecognition is accorded, nevertheless, as under the various provisions of section 112, nonrecognition will not be accorded to such taxable transaction. In other words, the provisions of section 371 do not extend in any case to gain or loss other than that realized from and directly attributable to a disposition of property as such, or the receipt of a corporate distribution as such, in an exchange, sale, or distribution specifically described in section 371.

The application of the provisions of Supplement R is intended to result only in postponing the recognition of gain or loss until a disposition of property is made which is not covered by such provisions, and the continuation of the basis as provided in section 372 is designed to effect this result. Although the time of recognition may be shifted, there must be a true reflection of income in all cases, and it is intended that the provisions of Supplement R shall not be construed or applied in such a way as to defeat this purpose.

ART. 371-2. *Exchanges of stock or securities solely for stock or securities.*—The exchange, without the recognition of gain or loss, that is provided for in section 371 (a) must be one in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are exchanged solely for stock or securities other than stock or securities which constitute nonexempt property. An exchange is not within the provisions of section 371 (a), unless the stock or securities transferred and those received are stock or securities as defined by section 373 (f). The stock or securities which may be received without the recognition of gain or loss are not limited to stock or securities in the corporation from which they are received. An exchange within the provisions of section 371 (a) may be a transaction between the holder of stock or securities and the corporation which issued the stock or securities. Also the exchange may be made by a holder of stock or securities with an associate company (*i. e.,* a corporation in the same holding-company system with the issuing corporation) which is a registered holding company or a majority-owned subsidiary company. In either case, the nonrecognition provisions of section 371 (a) apply only to the holder of the stock or securities. However, the transferee corporation must be acting in obedience to an order of the Securities and Exchange Commission directed to such corporation, if no gain or loss is to be recognized to the holder of the stock or securities who makes the exchange with such corporation. See also section 371 (b), in case the holder of the stock or securities is a registered holding company or an associate company of a registered holding company. An exchange is not within the provisions of section 371 (a) if it is within the provisions of section 371 (d), relating to transfers within a system group. For further limitations, see section 371 (f).

ART. 371-3. *Exchanges of property for property by corporations.*—The nonrecognition of gain or loss provided for in section 371 (b) is limited to an exchange by a transferor corporation which is (1) a registered holding company or (2) an associate company of a registered holding company. No restriction is imposed with respect to the class of property which may be transferred by the transferor corporation, but in order that all of the transferor corporation's gain from the exchange be nonrecognized (see section 371 (e)), no part of the property received by such corporation may consist of nonexempt property, though the receipt, in part, of nonexempt property by the transferor corporation does not prevent nonrecognition of all of its loss from the exchange under section 371 (e). It is essential to the nonrecognition either of gain or loss that in making the exchange the transferor corporation shall be acting in obedience to an order of the Securities and Exchange Commission reciting that such exchange by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which such corporation is a member. An exchange is not within the provisions of section 371 (b), if it is within the provisions of section 371 (d), relating to transfers within a system group. For further limitations, see section 371 (f).

Example: The A Corporation, a registered holding company, is a member of holding-company system No. 1 which comprises an integrated utility system in region X, except for the fact that the A Corporation owns all of the voting stock of the B Corporation with transmission lines in region Y. The transmission lines of the B Corporation have an adjusted basis of $300,000 and a fair market value of $325,000. The C Corporation, a registered holding company, is a member of holding-company system No. 2 which comprises an integrated utility system in region Y, except for the fact that the C Corporation owns all of the voting stock of the D Corporation, an operating company with a generating plant and transmission lines in region X. The generating plant and transmission lines of the D Corporation have an adjusted basis of $275,000 and a fair market value of $325,000. In obedience to an appropriate order of the Securities and Exchange Commission relative to the integration of holding-company system No. 1, the B Corporation transfers its transmission lines in region Y to the D Corporation in exchange for the generating plant and transmission lines of the D Corporation in region X. Under section 371 (b), no gain is recognized to the B Corporation upon the exchange. However, the provisions of section 371 (b) do not apply to the disposition by the D Corporation of its generating plant and transmission lines in region X unless such disposition is made in obedience to an appropriate order of the Securities and Exchange Commission which relates to such disposition and recites that such disposition is necessary or appropriate to the integration of holding-company system No. 2.

ART. 371-4. *Distribution solely of stock or securities.*—If, without any surrender of his stock or securities as defined in section 373 (f), a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company receives stock or securities in such corporation or owned by such corporation, no gain to the shareholder will be recognized with respect to the stock or securities received by such shareholder which do not constitute nonexempt property, if the distribution to such shareholder is made by the distributing corporation in obedience to an order of the Securities and Exchange Commission directed to such corporation. A distribution is not within the provisions of section 371 (c) if it is within the provisions of section 371 (d), relating to transfers within a system group. A distribution is also not within the provisions of section 371 (c) if it involves a surrender by the shareholder of stock or securities or a transfer by the shareholder of property in exchange for the stock or securities received by the shareholder. For further limitations, see section 371 (f).

ART. 371-5. *Transfers within system group.*—The nonrecognition of gain or loss provided for in section 371 (d) (1) is applicable to an exchange of property for other property (including money and other nonexempt property). In order for any exchange to come within such section, all the parties to the exchange must be corporations which are members of the same system group. The term "system group" is defined in section 373 (d).

Section 371 (d) (1) also provides for nonrecognition of gain to a corporation which is a member of a system group if property (including money or other nonexempt property) is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, without the surrender by such shareholder of stock or securities in the distributing corporation.

As stated in article 371-1, nonrecognition of gain or loss will not be accorded to a transaction not clearly provided for in Supplement R, even though such transaction occurs simultaneously or in connection with an exchange, sale, or distribution to which nonrecognition is specifically accorded. Therefore, nonrecognition will not be accorded to any gain or loss realized from the discharge, or the removal of the burden, of the pecuniary obligations of a member of a system group, even though such obligations are acquired upon a transfer or distribution specifically described in section 371 (d) (1); but the fact that the acquisition of such obligations was upon a transfer or distribution specifically described in section 371 (d) (1) will, because of the basis provisions of section 372 (d), affect the cost to the member of such discharge or its equivalent. Thus, section 371 (d) (1) does not provide for the nonrecognition of any gain or loss realized from the discharge of the indebtedness of a member of a system group as the result of the acquisition in exchange, sale, or distribution of its own bonds, notes, or other evidences of indebtedness which were acquired by another member of the same system group for a consideration less or more than the issuing price thereof (with proper adjustments for amortization of premiums or discounts).

Example: Suppose that the A Corporation and the B Corporation are both members of the same system group; that the A Corporation holds at a cost of $900 a bond issued by the B Corporation at par, $1,000; and that the A Corporation and the B Corporation enter into an exchange subject to the provisions of section 371 (d) (1) in which the $1,000 bond of the B Corporation is transferred from the A Corporation to the B Corporation. The $900 basis reflecting the cost to the A Corporation which would have been the basis available to the B Corporation if the property transferred to it had been something other than its own securities (see article 372-4) will, in this type of transaction, reflect the cost to the B Corporation of effecting a retirement of its own $1,000 bond. The $100 gain of the B Corporation reflected in the retirement will therefore be recognized.

No exchange or distribution may be made without the recognition of gain or loss as provided for in section 371 (d) (1), unless all the corporations which are parties to such exchange or distribution are acting in obedience to an order of the Securities and Exchange Commission. If an exchange or distribution is within the provisions of section 371 (d) (1) and also may be considered to be within some other provision of section 371, it shall be considered that only the provisions of section 371 (d) (1) apply and that the nonrecognition of gain or loss upon such exchange or distribution is by virtue of that section.

ART. 371-6. *Sale of stock or securities received upon exchange by members of system group.*—Section 371 (d) (2) provides that to the extent that property received upon an exchange by corporations which are members of the same system group consists of stock or securities *issued* by the corporation from which such property was received, such stock or securities may, under certain specifically described circumstances, be sold to a party not a member of the system group, without the recognition of gain or loss to the selling corporation. The nonrecognition of gain or loss is limited, in the case of stock, to a sale of stock which is preferred as to both dividends and assets. The stock or securities must have been received upon an exchange with respect to which section 371 (d) (1) operated to prevent recognition of gain or loss to any party to the exchange. Nonrecognition of gain or loss upon the sale of such stock or securities is permitted only if the proceeds derived from the sale are applied in retirement or cancellation of stock or securities of the selling corporation which were outstanding at the time the exchange was made. It is also essential to nonrecognition of gain or loss upon the sale that both the sale of the stock or securities and the application of the proceeds derived therefrom be made in obedience to an order of the Securities and Exchange Commission. If any part of the proceeds derived from the sale is not applied in making the required retirement or cancellation of stock or securities and if the sale is otherwise within the provisions of section 371 (d) (2), the gain resulting from the sale shall be recognized, but in an amount not in excess of the proceeds which are not so applied. In any event, if the proceeds derived from the sale of the stock or securities exceed the fair market value of such stock or securities at the time of the exchange through which they were acquired by the selling corporation, the gain resulting from the sale is to be recognized to the extent of such excess. Section 371 (d) (2) does not provide for the nonrecognition of any gain resulting from the retirement of bonds, notes, or other evidences of indebtedness for a consideration less than the issuing price thereof. Also, that section does not provide for the nonrecognition of gain or loss upon the sale of any stock or securities received upon a distribution or otherwise than upon an exchange.

Example: The X Corporation and the Y Corporation, both of which make their income tax returns on a calendar year basis, are members of the same system group. As part of an exchange in which section 371 (d) (1) is applicable the Y Corporation on June 1, 1938, issues to the X Corporation 1,000 shares of class A stock, preferred as to both dividends and assets. The fair market value of such stock at the time of issuance is $90,000 and its basis to the X Corporation is $75,000. On December 1, 1938, in obedience to an appropriate order of the Securities and Exchange Commission, the X Corporation sells all of such stock to the public for $100,000 and applies $95,000 of this amount to the retirement of its own bonds, which were outstanding on June 1, 1938. The remaining $5,000 is not used to retire any of the X Corporation's stock or securities. Of the total gain of $25,000 realized on the disposition of the Y Corporation stock only $10,000 is recognized, being the difference between the fair market value of the stock when acquired and the amount for which it was sold, since such amount is greater than the portion ($5,000) of the proceeds not applied to the retirement of the X Corporation's stock or securities.

If in the above example the stock acquired by the X Corporation had not been stock of the Y Corporation issued to the X Corporation or if it had been stock not preferred as to both dividends and assets, the full amount of the gain ($25,000) realized upon its disposition would have been recognized, regardless of what was done with the proceeds.

ART. 371-7. *Exchanges in which money or other nonexempt property is received.*—Under section 371 (e) (1), if in any exchange (not within any of the provisions of section 371 (d)) in which (*a*) stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary are exchanged for stock or securities as provided for in section 371 (a), or (*b*) property of a corporation which is a registered holding company or an associate company of a registered holding company is exchanged for other property as provided for in section 371 (b), there is received by the taxpayer money or other nonexempt property (in addition to property permitted to be received without recognition of gain), then—

(1) The gain, if any, to the taxpayer is to be recognized in an amount not in excess of the sum of the money and the fair market value of the other nonexempt property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent.

If money or other nonexempt property is received from a corporation in an exchange described in this article and if the distribution of such money or other nonexempt property by or on behalf of such corporation has the effect of the distribution of a taxable dividend, then, as provided in section 371 (e) (2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) the remainder of the gain so recognized shall be taxed as a gain from the exchange of property.

ART. 371-8. *Requirements with respect to order of Securities and Exchange Commission.*—The term "order of the Securities and Exchange Commission" is defined in section 373 (a). In addition to the requirements specified in that definition, section 371 (f) provides that the provisions of section 371 shall not apply to an exchange or distribution unless each of the following requirements is met:

(1) The order of the Securities and Exchange Commission must recite that the exchange or distribution is necessary or appropriate to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935.

(2) The order shall specify and itemize the stock and securities and other property (including money) which are ordered to be transferred and received upon the exchange or distribution, so as clearly to identify such property.

(3) The exchange or distribution shall be made in obedience to the order and shall be completed within the time prescribed in such order.

These requirements were not designed merely to simplify the administration of the provisions of section 371, and they are not to be considered as pertaining only to administrative matters. Each one of the three requirements is of the essence, and must be met if gain or loss is not to be recognized upon the transaction.

ART. 371-9. *Nonapplication of other provisions of the Act.*—The effect of section 371 (g) is that an exchange, sale, or distribution which is within section 371 shall, with respect to the nonrecognition of gain or loss and the determination of basis, be governed only by Supplement R, the purpose being to prevent overlapping of the provisions of such supplement and other provisions of the Act. In other words, if by virtue of section 371 any portion of a person's gain or loss on any particular exchange, sale or distribution is not to be recognized, then the gain or loss of such person shall be nonrecognized only to the extent provided in section 371, regardless of what the result might have been under section 112 if Supplement R had not been enacted; and similarly, the basis in the hands of such person of the property received by him in such transaction shall be the basis provided by section 372, regardless of what the basis of such property might have been under section 113 if Supplement R had not been enacted. On the other hand, if section 371 does not provide for the nonrecognition of any portion of a person's gain or loss (whether or not such person is another party to the same transaction referred to above), then the gain or loss of such person shall be recognized or nonrecognized to the extent provided for by other provisions of the Act as if Supplement R had not been enacted; and similarly, the basis in his hands of the property received by him in such transaction shall be the basis provided by other provisions of the Act as if Supplement R had not been enacted.

ART. 371-10. *Records to be kept and information to be filed with returns.*—

(*a*) Every holder of stock or securities who receives stock or securities and other property (including money) upon an exchange shall, if the exchange is made with a corporation acting in obedience to an order of the Securities and Exchange Commission, file as a part of his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

(1) A clear description of the stock or securities transferred in the exchange, together with a statement of the cost or other basis of such stock or securities.

(2) The name and address of the corporation from which the stock or securities were received in the exchange.

(3) A statement of the amount of stock or securities and other property (including money) received from the exchange. The amount of each kind of stock or securities and other property received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(*b*) Each corporation which is a party to an exchange made in obedience to an order of the Securities and Exchange Commission directed to such corporation shall file as a part of its income tax return for its taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

(1) A copy of the order of the Securities and Exchange Commission directed to such corporation, in obedience to which the exchange was made.

(2) A certified copy of the corporate resolution authorizing the exchange.

(3) A clear description of all property, including all stock or securities, transferred in the exchange, together with a complete statement of the cost or other basis of each class of property.

(4) The date of acquisition of any stock or securities transferred in the exchange, and, if any of such stock or securities were acquired by the corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The name and address of all persons to whom any property was transferred in the exchange.

(6) If any property transferred in the exchange was transferred to another corporation, a copy of any order of the Securities and Exchange Commission directed to the other corporation, in obedience to which the exchange was made by such other corporation.

(7) If the corporation transfers any nonexempt property, the amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the exchange.

(8) A statement of the amount of stock or securities and other property (including money) received upon the exchange, including a statement of all distributions or other disposition made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the exhange.

(9) A statement showing as to each class of its stock the number of shares and percentage owned by any other corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(*c*) Each shareholder who receives stock or securities or other property (including money) upon a distribution made by a corporation in obedience to an order of the Securities and Exchange Commission shall file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of all facts pertinent to the nonrecognition of gain upon such distribution, including—

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of stock or securities or other property received upon the distribution, including (in case the shareholder is a corporation) a statement of all distributions or other disposition made of such stock or securities or other property by the shareholder. The amount of each class of stock or securities and each kind of property shall be stated on the basis of the fair market value thereof at the date of the distribution.

If the shareholder is a corporation, a statement showing as to each class of its stock the number of shares and percentage owned by a registered holding company or a majority-owned subsidiary company of a registered holding company, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(*d*) Every corporation making a distribution in obedience to an order of the Securities and Exchange Commission shall file as a part of its income tax return for its taxable year in which the distribution is made a complete statement of all facts pertinent to the nonrecognition of gain to the distributee upon such distribution, including—

(1) A copy of the order of the Securities and Exchange Commission, in obedience to which the distribution was made.

(2) A certified copy of the corporate resolution authorizing the distribution.

(3) A statement of the amount of stock or securities or other property (including money) distributed to each shareholder. The amount of each kind of stock or securities or other property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(4) The date of acquistion of the stock or securities distributed, and, if any of such stock or securities were

acquired by the distributing corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the distribution.

(6) A statement showing as to each class of its stock the number of shares and percentage owned by any other corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(*e*) Each corporation which is a member of a system group and which in obedience to an order of the Securities and Exchange Commission sells stock or securities received upon an exchange (made in obedience to an order of the Securities and Exchange Commission) and applies the proceeds derived therefrom in retirement or cancellation of its own stock or securities shall file as a part of its income tax return for the taxable year in which the sale is made a complete statement of all facts pertaining to the nonrecognition of gain or loss upon such sale, including—

(1) A copy of the order of the Securities and Exchange Commission in obedience to which the sale was made.

(2) A copy of the order of the Securities and Exchange Commission in obedience to which the proceeds derived from the sale were applied in whole or in part in the retirement or cancellation of its stock or securities.

(3) A certified copy of the corporate resolutions authorizing the sale of the stock or securities and the application of the proceeds derived therefrom.

(4) A clear description of the stock or securities sold, including the name and address of the corporation by which they were issued.

(5) The date of acquisition of the stock or securities sold, together with a statement of the fair market value of such stock or securities at the date of acquisition, and a copy of all orders of the Securities and Exchange Commission in obedience to which such stock or securities were acquired.

(6) The amount of the proceeds derived from such sale.

(7) The portion of the proceeds of such sale which was applied in retirement or cancellation of its stock or securities, together with a statement showing how long such stock or securities were outstanding prior to retirement or cancellation.

(8) The issuing price of its stock or securities which were retired or canceled.

(*f*) Permanent records in substantial form shall be kept by every taxpayer who participates in an exchange or distribution made in obedience to an order of the Securities and Exchange Commission, showing the cost or other basis of the property transferred and the amount of stock or securities and other property (including money) received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received on the exchange or distribution.

SEC. 372. *Basis for determining gain or loss.*—(*a*) *Exchanges generally.*—If the property was acquired upon an exchange subject to the provisions of section 371 (a), (b), or (e), the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 371 (a) or (b) to be received without the recognition of gain or loss, and in part of nonexempt property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such nonexempt property (other than money) an amount equivalent to its fair market value at the date of the exchange. This subsection shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

(*b*) *Transfers to corporations.*—If, in connection with a transfer subject to the provisions of section 371 (a), (b), or (e), the property was acquired by a corporation, either as paid-in surplus or as a contribution to capital, or in consideration for stock or securities issued by the corporation receiving the property (including cases where part of the consideration for the transfer of such property to the corporation consisted of property or money in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

(*c*) *Distributions of stock or securities.*—If the stock or securities were received in a distribution subject to the provisions of section 371 (c), then the basis in the case of the stock in respect of which the distribution was made shall be apportioned, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, between such stock and the stock or securities distributed.

(*d*) *Transfers within system group.*—If the property was acquired by a corporation which is a member of a system group upon a transfer or distribution described in section 371 (d) (1), then the basis shall be the same as it would be in the hands of the transferor; except that if such property is stock or securities issued by the corporation from which such stock or securities were received and they were issued (1) as the sole consideration for the property transferred to such corporation, then the basis of such stock or securities shall be either (A) the same as in the case of the property transferred therefor, or (B) the fair market value of such stock or securities at the time of their receipt, whichever is the lower; or (2) as part consideration for the property transferred to such corporation, then the basis of such stock or securities shall be either (A) an amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities at the time of their receipt bears to the total fair market value of the entire consideration received, or (B) the fair market value of such stock or securities at the time of their receipt, whichever is the lower.

ART. 372-0. *Basis for determining gain or loss.*—Section 113 (a) (17) provides that if property is acquired in any manner described in section 372, the basis shall be that prescribed in such section with respect to such property. Section 372 therefore expands section 113 (a) in order to make adequate provisions with respect to the basis of property acquired in a transfer made in obedience to an order of the Securities and Exchange Commission in connection with which the recognition of gain or loss is prohibited by the provisions of section 112 (b) (8) and section 371 with respect to the whole or any part of the property received. In general, it is intended that the basis for determining gain or loss pertaining to the property prior to its transfer, as well as the basis for determining the amount of depreciation or depletion deductible and the amount of earnings or profits available for distribution, shall continue notwithstanding the nontaxable conversion of the asset in form or its change in ownership. The continuance of the basis may be reflected in a shift thereof from one asset to another in the hands of the same owner, or in its transfer with the property from one owner into the hands of another. See also article 371-1.

ART. 372-1. *Basis of property acquired upon exchanges under section 371 (a), 371 (b), or 371 (e).*—In the case of an exchange of stock or securities for stock or securities as described in section 371 (a), or an exchange of property for property as described in section 371 (b), if no part of the gain or loss upon such exchange was recognized under section 371, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

If, in an exchange of stock or securities as described in section 371 (a), or in an exchange of property for property as described in section 371 (b), gain to the taxpayer was recognized under section 371 (e), on account of the receipt of money, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized upon the exchange. If, upon such exchange, there were received by the taxpayer money and other nonexempt property (not permitted to be received without the recognition of gain), and gain from the transaction was recognized under section 371 (e), the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of money received and increased by the amount of gain recognized, must be apportioned to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of such basis to the properties received, there must be assigned to the nonexempt property (other than money) an amount equivalent to its fair market value at the date of the exchange.

Section 371 (e) provides that no loss may be recognized on an exchange of stock or securities for stock or securities as described in section 371 (a), or on an exchange of property for property as described in section 371 (b), although the taxpayer receives money or other nonexempt property from the transaction. However, the basis of the property (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be apportioned to the properties received, and for this purpose there must be allocated to the nonexempt property (other than money) an amount of such basis equivalent to the fair market value of such nonexempt property at the date of the exchange.

Section 372 (a) does not apply in ascertaining the basis of property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it. For the rule in such cases, see section 372 (b).

ART. 372-2. *Basis of property acquired by corporation under section 371 (a), 371 (b), or 371 (e) as contribution of capital or surplus, or in consideration for its own stock or securities.*—If, in connection with an exchange of stock or securities for stock or securities as described in section 371 (a), or an exchange of property for property as described in section 371 (b), or an exchange as described in section 371 (e), property is acquired by a corporation by the issuance of its stock or securities, the basis of such property shall be determined under section 372 (b). If the corporation issued its stock or securities as part or sole consideration for the property acquired, the basis of the property in the hands of the acquiring corporation is the basis (adjusted to the date of the exchange) which the property would have had in the hands of the transferor if the transfer had not been made, increased in the amount of gain or decreased in the amount of loss recognized under section 371 to the transferor upon the transfer. If any property is acquired by a corporation from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property to the corporation is the basis (adjusted to the date of acquisition) of the property in the hands of the transferor.

ART. 372-3. *Basis of stock or securities acquired by shareholder upon tax-free distribution under section 371 (c).*—Under section 372 (c), if there was distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company stock or securities (other than stock or securities which are nonexempt property), and if by virtue of section 371 (c) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the stock or securities received upon the distribution shall be determined in accordance with the following rules:

(1) If the stock or securities received upon the distribution consist solely of stock in the distributing corporation and the stock received is all of substantially the same character and preference as the stock in respect of which the distribution is made, the basis of each share will be the quotient of the cost or other basis of the old shares of stock divided by the total number of the old and the new shares.

(2) If the stock or securities received upon the distribution are in whole or in part stock in a corporation other than the distributing corporation, or are in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists in whole or in part of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of the foregoing provisions stocks or securities in one corporation are different in class from stocks or securities in another corporation, and, in general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security so that different values may properly be assigned thereto, will constitute a difference in class. As to the basis of stock or securities distributed by one member of a system group to another member of the same system group, see section 372 (d).

ART. 372-4. *Basis of property acquired under section 371 (d) in transactions between corporations of the same system group.*—If property was acquired by a corporation which is a member of a system group, from a corporation which is a member of the same system group, upon a transfer or distribution described in section 371 (d) (1), then as a general rule the basis of such property in the hands of the acquiring corporation is the basis which such property would have had in the hands of the transferor if the transfer or distribution had not been made.

Except as otherwise indicated in this article, this rule will apply equally to cases in which the consideration for the property acquired consists of stock or securities, money, and other property, or any of them, but it is contemplated that an ultimate true reflection of income will be obtained in all cases, notwithstanding any peculiarities in form which the various transactions may assume. See the example in article 371-5.

An exception to this general rule is provided for in case the property acquired consists of stock or securities issued by the corporation from which such stock or securities were received. If such stock or securities were the sole consideration for the property transferred to the corporation issuing such stock or securities, then the basis of the stock or securities shall be (1) the same as the basis (adjusted to the time of the transfer) of the property transferred for such stock or securities, or (2) the fair market value of such stock or securities at the time of their receipt, whichever is the lower. If such stock or securities constituted only part consideration for the property transferred to the corporation issuing such stock or securities, then the basis shall be an amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities on their receipt bears to the total fair market value of the entire consideration received, except that the fair market value of such stock or securities at the time of their receipt shall be the basis therefor, if such value is lower than such amount.

Example: Suppose the A Corporation has property with an adjusted basis of $600,000 and in an exchange in which section 371 (d) (1) is applicable, transfers such property to the B Corporation in exchange for a total consideration of $1,000,000, consisting of (1) cash in the amount of $100,000, (2) tangible property having a fair market value of $400,000 and an adjusted basis in the hands of the B Corporation of $300,000, and (3) stock or securities issued by the B Corporation with a par value and a fair market value as of the date of their receipt in the amount of $500,000. The basis to the B Corporation of the property received by it is $600,000, which is the adjusted basis of such property in the hands of the A Corporation. The basis to the A Corporation of the assets (other than cash) received by it is as follows: Tangible property, $300,000, the adjusted basis of such property to the B Corporation, the former owner; stock or securities issued by the B Corporation, $300,000, an amount equal to 500,000/1,000,000ths of $600,000.

Suppose that the property of the A Corporation transferred to the B Corporation had an adjusted basis of $1,100,000 instead of $600,000, and that all other factors in the illustration in the preceding paragraph remain the same. In such case the basis to the A Corporation of the stock or securities in the B Corporation is $500,000, which was the fair market value of such stock or securities at the time of their receipt by the A Corporation, and not the amount established as 500,000/1,000,000ths of $1,100,000, or $550,000.

SEC. 373. *Definitions.*—As used in this supplement—

(a) the term "order of the Securities and Exchange Commission" means an order (1) issued after the date of enactment of this Act and prior to January 1, 1940, by the Securities and Exchange Commission to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935, or (2) issued by the Commission subsequent to December 31, 1939, in which it is expressly stated that an order of the character specified in clause (1) is amended or supplemented, and (3) which has become final in accordance with law.

(b) The terms "registered holding company", "holding-company system", and "associate company" shall have the meanings assigned to them by section 2 of the Public Utility Holding Company Act of 1935.

(c) The term "majority-owned subsidiary company" of a registered holding company means a corporation, stock of which, representing in the aggregate more than 50 per centum of the total combined voting power of all classes of stock of such corporation entitled to vote (not including stock which is entitled to vote only upon default or nonpayment of dividends or other special circumstances) is owned wholly by such registered holding company, or partly by such registered holding company and partly by one or more majority-owned subsidiary companies thereof, or by one or more majority-owned subsidiary companies of such registered holding company.

(d) The term "system group" means one or more chains of corporations connected through stock ownership with a common parent corporation if—

(1) At least 90 per centum of each class of the stock (other than stock which is preferred as to both dividends and assets) of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations; and

(2) The common parent corporation owns directly at least 90 per centum of each class of the stock (other than stock which is preferred as to both dividends and assets) of at least one of the other corporations; and

(3) Each of the corporations is either a registered holding company or a majority-owned subsidiary company.

(e) The term "nonexempt property" means—

(1) Any consideration in the form of a cancellation or assumption of debts or other liabilities (including a continuance of encumbrances subject to which the property was transferred);

(2) Short-term obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding twenty-four months, exclusive of days of grace;

(3) Securities issued or guaranteed as to principal or interest by a government or subdivision thereof (including those issued by a corporation which is an instrumentality of a government or subdivision thereof);

(4) Stock or securities which were acquired after February 28, 1938, unless such stock or securities (other than obligations described as nonexempt property in paragraph (2) or (3), were acquired in obedience to an order of the Securities and Exchange Commission;

(5) Money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in paragraph (2) or (3).

(f) The term "stock or securities" means shares of stock in any corporation, certificates of stock or interest in any corporation, notes, bonds, debentures, and evidences of indebtedness (including any evidence of an interest in or right to subscribe to or purchase any of the foregoing).

ART. 373-1. *Definitions—(a) "Order of the Securities and Exchange Commission."*—An order of the Securities and Exchange Commission as defined in section 373 (a) must be issued after May 28, 1938 (the date of the enactment of the Revenue Act of 1938), and must be issued under the authority of section 11 (b) or 11 (e) of the Public Utility Holding Company Act of 1935 to effectuate the provisions of section 11 (b) of such Act (or must amend or supplement an order so issued and expressly state that it amends or supplements such an order). In all cases the order must have become final in accordance with law; *i. e.*, it must be valid, outstanding, and not subject to further appeal. See further sections 373 (a) and 371 (f). Section 11 (b) of the Public Utility Holding Company Act of 1935 provides:

(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

(1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system: *Provided, however,* That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—

(A) Each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;

(B) All of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country; and

(C) The continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.

The Commission may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) which the Commission shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems.

(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company.

The Commission may by order revoke or modify any order previously made under this subsection, if, after notice and opportunity for hearing, it finds that the conditions upon which the order was predicated do not exist. Any order made under this subsection shall be subject to judicial review as provided in section 24.

Section 11 (e) of the Public Utility Holding Company Act of 1935 provides:

(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

(b) "Registered holding company," "holding-company system," and "associate company."—Under section 5 of the Public Utility Holding Company Act of 1935 any holding company may register by filing with the Securities and Exchange Commission a notification of registration, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. A holding company shall be deemed to be registered upon receipt by the Securities and

Exchange Commission of such notification of registration. The term "registered holding company" as used in these regulations means a holding company whose notification of registration has been so received and whose registration is still in effect under section 5 of the Public Utility Holding Company Act of 1935. Under section 2 (a) (7) of the Public Utility Holding Company Act of 1935, a corporation is a holding company (unless it is declared not to be such by the Securities and Exchange Commission), if such corporation directly or indirectly owns, controls, or holds with power to vote 10 percent or more of the outstanding voting securities of a public-utility company (*i. e.*, an electric utility company or a gas utility company as defined by such Act) or of any other holding company. A corporation is also a holding company if the Securities and Exchange Commission determines, after notice and opportunity for hearing, that such corporation directly or indirectly exercises (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility company (*i. e.*, an electric utility company or a gas utility company as defined by such Act) or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such corporation be subject to the obligations, duties, and liabilities imposed upon holding companies by the Public Utility Holding Company Act of 1935. An electric utility company is defined by section 2 (a) (3) of the Public Utility Holding Company Act of 1935 to mean a company which owns or operates facilities used for the generation, transmission, or distribution of electrical energy for sale, other than sale to tenants or employees of the company operating such facilities for their own use and not for resale; and a gas utility company is defined by section 2 (a) (4) of such Act to mean a company which owns or operates facilities used for the distribution at retail (other than distribution only in enclosed portable containers, or distribution to tenants or employees of the company operating such facilities for their own use and not for resale) of natural or manufactured gas for heat, light, or power. However, under certain conditions the Securities and Exchange Commission may declare a company not to be an electric utility company or a gas utility company, as the case may be, in which event the company shall not be considered an electric utility company or a gas utility company.

The term "holding-company system" has the meaning assigned to it by section 2 (a) (9) of the Public Utility Holding Company Act of 1935, and hence means any holding company, together with all its subsidiary companies (*i. e.*, subsidiary companies within the meaning of section 2 (a) (8) of such Act, which in general include all companies 10 percent of whose outstanding voting securities is owned directly or indirectly by such holding company) and all mutual service companies of which such holding company or any subsidiary company thereof is a member company. The term "mutual service company" means a company approved as a mutual service company under section 13 of the Public Utility Holding Company Act of 1935. The term "member company" is defined by section 2 (a) (14) of such Act to mean a company which is a member of an association or group of companies mutually served by a mutual service company.

The term "associate company" has the meaning assigned to it by section 2 (a) (10) of the Public Utility Holding Company Act of 1935, and hence an associate company of a company is any company in the same holding-company system with such company.

(*c*) *"Majority-owned subsidiary company."*—The term "majority-owned subsidiary company" is defined in section 373 (c). Direct ownership by a registered holding company of more than 50 percent of the specified stock of another corporation is not necessary to constitute such corporation a majority-owned subsidiary company. To illustrate, if the H Corporation, a registered holding company, owns 51 percent of the common stock of the A Corporation and 31 percent of the common stock of the B Corporation, and the A Corporation owns 20 percent of the common stock of the B Corporation (the common stock in each case being the only stock entitled to vote), both the A Corporation and the B Corporation are majority-owned subsidiary companies.

(*d*) *"System group."*—The term "system group" is defined in section 373 (d) to mean one or more chains of corporations connected through stock ownership with a common parent corporation, if at least 90 percent of each class of stock (other than stock preferred as to both dividends and assets) of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations and the common parent corporation owns directly at least 90 percent of each class of such stock of at least one of the other corporations; but no corporation is a member of a system group if it is not either a registered holding company or a majority-owned subsidiary company. It is to be observed that while the type of stock which must be at least 90 percent owned for the purpose of this definition (*i. e.*, stock not preferred as to both dividends and assets) may be different from the voting stock which must be more than 50 percent owned for the purpose of the definition of a majority-owned subsidiary company under section 373 (c), yet as a general rule both types of ownership tests must be met under section 373 (d), since a corporation, in order to be a member of a system group, must also be a registered holding company or a majority-owned subsidiary company.

(*e*) *"Nonexempt property."*—The term "nonexempt property" is defined by section 373 (e) to include—

(1) The amount of any consideration in the form of a cancellation or assumption of debts or other liabilities (including a continuance of encumbrances subject to which the property was transferred). To illustrate, if in obedience to an order of the Securities and Exchange Commission the X Corporation, a registered holding company, transfers property to the Y Corporation in exchange for property (not nonexempt property) with a fair market value of $500,000, the X Corporation receives $100,000 of nonexempt property, if for example,

(A) The Y Corporation cancels $100,000 of indebtedness owed to it by the X Corporation;

(B) The Y Corporation assumes an indebtedness of $100,000 owed by the X Corporation to another company, the A Corporation; or

(C) The Y Corporation takes over the property conveyed to it by the X Corporation subject to a mortgage of $100,000.

(2) Short-term obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace.

(3) Securities issued or guaranteed as to principal or interest by a government or subdivision thereof (including those issued by a corporation which is an instrumentality of a government or subdivision thereof).

(4) Stock or securities which were acquired after February 28, 1938, unless such stock or securities were acquired in obedience to an order of the Securities and Exchange Commission (as defined in section 373 (a)) and are not nonexempt property within the meaning of section 373 (e) (2) or (3).

(5) Money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in section 373 (e) (2) or (3). The term "the right to receive money" includes, among other items, accounts receivable, claims for damages, and rights to refunds of taxes.

(*f*) *"Stock or securities."*—The term "stock or securities" is defined in section 373 (f) for the purposes of sections 371 to 373, inclusive. As therein defined the term includes voting trust certificates and stock rights or warrants.

CHAPTER XXXVII

Surtax on Personal Holding Companies

Title IA—Personal Holding Companies

SEC. 401. *Surtax on personal holding companies.*—There shall be levied, collected, and paid, for each taxable year, upon the undistributed Title IA net income of every personal holding company (in addition to the taxes imposed by Title I) a surtax equal to the sum of the following:

(1) 65 per centum of the amount thereof not in excess of $2,000; plus

(2) 75 per centum of the amount thereof in excess of $2,000.

ART. 401-1. *Surtax on personal holding companies.*—Section 401 imposes for each taxable year beginning after December 31, 1937 (in addition to the taxes imposed by Title I), a graduated income tax or surtax upon corporations classified as personal holding companies and, under the circumstances specified in section 402 (c), upon an affiliated group of railroad corporations. Corporations so classified are exempt from the surtax on corporations improperly accumulating surplus imposed by section 102, but are not exempt from the other taxes imposed by Title I. Unlike the surtax imposed by section 102, the surtax imposed by section 401 applies to all personal holding companies defined as such in section 402 and article 402-1, regardless of whether or not they were formed or availed of to accumulate earnings or profits for the purpose of avoiding surtax upon shareholders. The surtax imposed by section 401 is 65 percent of the amount of the undistributed Title IA net income not in excess of $2,000, and 75 percent of the amount of the undistributed Title IA net income in excess of $2,000.

A foreign corporation, whether resident or nonresident, which is classified as a personal holding company under section 402 (not including a foreign personal holding company as defined in section 331) is subject to the tax imposed by section 401 with respect to its income from sources within the United States even though such income is not fixed or determinable annual or periodical income specified in section 231 (a). (See section 119.) The term "personal holding company" as used in Title IA does not include a foreign corporation if (1) its gross income from sources within the United States for the period specified in section 119 (a) (2) (B) is less than 50 percent of its total gross income from all sources and (2) all of its stock outstanding during the last half of the taxable year is owned by nonresident alien individuals, whether directly or indirectly through other foreign corporations.

SEC. 402. *Definition of personal holding company.*—(a) *General rule.*—For the purposes of this title, and Title I, the term "personal holding company" means any corporation if—

(1) *Gross income requirement.*—At least 80 per centum of its gross income for the taxable year is personal holding company income as defined in section 403; but if the corporation is a personal holding company with respect to any taxable year beginning after December 31, 1936, then, for each subsequent taxable year, the minimum percentage shall be 70 per centum in lieu of 80 per centum, until a taxable year during the whole of the last half of which the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than 70 per centum of the gross income is personal holding company income; and

(2) *Stock ownership requirement.*—At any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

(b) *Exceptions.*—The term "personal holding company" does not include a corporation exempt from taxation under section 101, a bank as defined in section 104, a life insurance company, a surety company, a foreign personal holding company as defined in section 331, or a licensed personal finance company, under State supervision, at least 80 per centum of the gross income of which is lawful interest received from individuals each of whose indebtedness to such company did not at any time during the taxable year exceed $300 in principal amount, if such interest is not payable in advance or compounded and is computed only on unpaid balances.

(c) *Corporations making consolidated returns.*—If the common parent corporation of an affiliated group of corporations making a consolidated return under the provisions of section 141, satisfies the stock ownership requirement provided in section 402 (a) (2), and the income of such affiliated group, determined as provided in section 141, satisfies the gross income requirement provided in section 402 (a) (1), such affiliated group shall be subject to the surtax imposed by this title.

ART. 402-1. *Definition of personal holding company.*—A personal holding company is any corporation (other than a corporation specified in section 402 (b)) which for the taxable year meets (*a*) the gross income requirement specified in article 402-2, and (*b*) the stock ownership requirement specified in article 402-3. Both requirements must be satisfied and both must be met with respect to each taxable year.

ART. 402-2. *Gross income requirement.*—To meet the gross income requirement, it is necessary that either of the following percentages of gross income of the corporation for the taxable year be personal holding company income as defined in section 403:

(*a*) 80 percent or more; or

(*b*) 70 percent or more if the corporation has been classified as a personal holding company for any taxable year beginning after December 31, 1936, unless—

(1) a taxable year has intervened since the last taxable year for which it was so classified, during no part of the last half of which the stock ownership requirement specified in section 402 (a) (2) exists; or

(2) three consecutive years have intervened since the last taxable year for which it was so classified, during each of which its personal holding company income was less than 70 percent of its gross income.

In determining whether the personal holding company income is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts. For a further discussion of what constitutes "gross income," see section 22 (a) and the regulations prescribed under that section.

ART. 402-3. *Stock ownership requirement.*—To meet the stock ownership requirement, it is necessary that at some time during the last half of the taxable year more than 50 percent in value of the outstanding stock of the corporation be owned, directly or indirectly, by or for not more than five individuals. For such purpose, the ownership of the stock must be determined as provided in section 404 and articles 404 (a)-1 to 404 (a)-7 and article 404 (b)-1.

In the event of any change in the stock outstanding during the last half of the taxable year, whether in the number of shares or classes of stock, or whether in the ownership thereof, the conditions existing immediately prior and subsequent to each change must be taken into consideration.

In determining whether the statutory conditions with respect to stock ownership are present at any time during the last half of the taxable year, the phrase "in value" shall, in the light of all the circumstances, be deemed the value of the corporate stock outstanding at such time (not including treasury stock). This value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class therein.

The rules stated in the last two preceding paragraphs are equally applicable in determining the stock ownership requirement specified in section 403 (e), relating to personal service contracts and in section 403 (f), relating to the use of corporation property by a shareholder. The stock ownership requirement specified in these sections relates, however, to the stock outstanding at any time during the entire taxable year and not merely during the last half thereof.

SEC. 403. *Personal holding company income.*—For the purposes of this title the term "personal holding company income" means the portion of the gross income which consists of:

(*a*) Dividends, interest (other than interest constituting rent as defined in subsection (g)), royalties (other than mineral, oil, or gas royalties), annuities.

(*b*) *Stock and securities transactions.*—Except in the case of regular dealers in stock or securities, gains from the sale or exchange of stock or securities.

(*c*) *Commodities transactions.*—Gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. This subsection shall not apply to gains by a producer, processor, merchant, or handler of the commodity which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others.

(*d*) *Estates and trusts.*—Accounts includible in computing the net income of the corporation under Supplement E of Title I; and gains from the sale or other disposition of any interest in an estate or trust.

(*e*) *Personal service contracts.*—(1) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and (2) amounts received from the sale or other disposition of such a contract. This subsection shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 per centum or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

(*f*) *Use of corporation property by shareholder.*—Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25 per centum or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property; whether such right is obtained directly from the corporation or by means of a sublease or other arrangement.

(*g*) *Rents.*—Rents, unless constituting 50 per centum or more of the gross income. For the purposes of this subsection the term "rents" means compensation, however designated, for the use of, or right to use, property, and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation; but does not include amounts constituting personal holding company income under subsection (f).

(*h*) *Mineral, oil, or gas royalties.*—Mineral, oil, or gas royalties, unless (1) constituting 50 per centum or more of the gross income, and (2) the deductions allowable under section 23 (a) (relating to expenses) other than compensation for personal services rendered by shareholders, constitute 15 per centum or more of the gross income.

ART. 403–1. *Personal holding company income.*—The term "personal holding company income" means the portion of the gross income which consists of the following:

(1) *Dividends.*—The term "dividends" includes dividends as defined in section 115 (a), and amounts required to be included in gross income under section 337 (b). It does not include stock dividends (to the extent they do not constitute income to the shareholders within the meaning of the sixteenth amendment to the Constitution), liquidating dividends, or other capital distributions referred to in section 115 (c) and (d).

(2) *Interest (other than interest constituting rent).*—The term "interest" means any amounts, includable in gross income, received for the use of money loaned except that it does not include interest constituting rent (see subparagraph (10)).

(3) *Royalties (other than mineral, oil, or gas royalties).*—The term "royalties" includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property. It does not include rents, or overriding royalties received by an operating company. As used in this paragraph the term "overriding royalties" means amounts received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid.

(4) *Annuities.*—The term "annuities" includes annuities only to the extent includible in the computation of gross income. (See section 22 (b) (2).)

(5) *Gains from the sale or exchange of stock or securities.*—The term "gains from the sale or exchange of stock or securities" as used in section 403 (b) applies to all gains (including gains from liquidating dividends and other distributions from capital) from the sale or exchange of stock or securities includible in gross income. The term "stock or securities" as used in section 403 (b) includes shares or certificates of stock, or interest in any corporation (including any joint-stock company, insurance company, association, or other organization classified as a corporation by the Act), certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral royalty, or lease, collateral trust certificates, voting trust certificates, stock rights or warrants, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange, obligations issued by or on behalf of a Government, State, Territory, or political subdivision thereof. In the case of "regular dealers in stock or securities" the term does not include gains derived from the sale or exchange of stock or securities made in the normal course of business. The term "regular dealer in stock or securities" means corporations with an established place of business regularly engaged in the purchase of stock or securities and their resale to customers, but such corporations are not dealers with respect to stock or securities held for speculation or investment.

(6) *Gains from futures transactions in commodities.*—Gains from futures transactions in commodities include gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, but do not include gains from cash transactions or gains by a producer, processor, merchant, or handler of the commodity, which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. In general, personal holding company income includes gains on futures contracts which are speculative. Futures contracts representing true hedges against price fluctuations in spot goods are not speculative transactions, though not concurrent with spot transactions. Futures contracts which are not hedges against spot transactions are speculative unless they are hedges against concurrent futures or forward sales or purchases.

(7) *Income from estates and trusts.*—The income from estates and trusts which is to be included in personal holding company income consists of the income from estates and trusts which is required to be included in the gross income of the corporation under sections 161 to 169, together with the gains derived by the corporation from the sale or other disposition of any interest in an estate or trust.

(8) *Amounts received under personal service contracts.*—Amounts includible in personal holding company income as amounts received under personal service contracts consist of amounts received pursuant to a contract under which the corporation is to furnish personal services, and amounts received from a sale or other disposition of such a contract, if—

(*a*) some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(*b*) at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description), as the one to perform such services. For this purpose the stock ownership must be determined as provided in section 404 and articles 404 (a)–1 to 404 (a)–7, article 404 (b)–1 and the last paragraph of article 402–3.

The application of section 403 (a) may be illustrated by the following examples:

Example (1): A, whose profession is that of an actor, owns all of the outstanding capital stock of the M Corporation. The M Corporation entered into a contract with A under which A was to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which A was to receive $10,000 a year from the M Corporation. The M Corporation entered into a contract with the O Corporation in which A was designated to perform personal services for the O Corporation in consideration of which the O Corporation was to pay the M Corporation $500,000 a year. The $500,000 received by the M Corporation from the O Corporation constitutes personal holding company income.

Example (2): The N Corporation, the entire outstanding capital stock of which is owned by four individuals, is engaged in engineering. The N Corporation entered into a contract with the O Corporation to perform engineering services for the O Corporation, in consideration of which the O Corporation was to pay the N Corporation $50,000. The individual who was to perform the services was not designated (by name or by description) in the contract and no one but the N Corporation had the right to designate (by name or by description) such individual. The $50,000 received by the N Corporation from the O Corporation does not constitute personal holding company income.

(9) *Compensation for use of property.*—The compensation for the use of, or the right to use, property of the corporation which is to be included in personal holding company income consists of amounts received as compensation (however designated and from whomsoever received) for the use of, or the right to use, property of the corporation in any case in which, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property, whether such right is obtained directly from the corporation or by means of a sublease or other arrangement. The property may consist of a yacht, a city residence, a country house, or any other kind of property. See section 404 and articles 404 (a)–1 to 404 (a)–7, article 404 (b)–1 and the last paragraph of article 402–3.

(10) *Rents (including interest constituting rent).*—The rents which are to be included in personal holding company income consist of compensation, however designated, including charter fees, etc., for the use of, or the right to use, real property, or any other kind of property and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation, but do not include amounts constituting personal holding company income under section 403 (f) and paragraph (9) of this article. However, rents do not constitute personal holding company income if constituting 50 percent or more of the gross income of the corporation.

(11) *Mineral, oil, or gas royalties.*—The income from mineral, oil, or gas royalties is to be included as personal holding company income, unless (A) the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year and (B) the aggregate amount of deductions allowable for expenses under section 23 (a) (other than compensation for personal services rendered by the shareholders of the corporation) equals 15 percent or more of the gross income of the corporation for the taxable year.

The term "mineral, oil, or gas royalties" means all royalties, except overriding royalties, received from any interest in mineral, oil, or gas properties. The term "mineral" includes the ores specified in paragraph (*d*) of article 23 (m)–1. As used in this paragraph the term "overriding royalties" means amounts received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid.

SEC. 404. *Stock ownership.*—(*a*) *Constructive ownership.*—For the purpose of determining whether a corporation is a personal holding company, insofar as such determination is based on stock ownership under section 402 (a) (2), section 403 (e), or section 403 (f)—

(1) *Stock not owned by individual.*—Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.

(2) *Family and partnership ownership.*—An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For the purposes of this paragraph the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(3) *Options.*—If any person has an option to acquire stock such stock shall be considered as owned by such person. For the purposes of this paragraph an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(4) *Application of family-partnership and option rules.*—Paragraphs (2) and (3) shall be applied—

(A) For the purposes of the stock ownership requirement provided in section 402 (a) (2), if, but only if, the effect is to make the corporation a personal holding company;

(B) For the purposes of section 403 (e) (relating to personal service contracts), or of section 403 (f) (relating to the use of property by shareholders), if, but only if, the effect is to make the amounts therein referred to includible under such subsection as personal holding company income.

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

(6) *Option rule in lieu of family and partnership rule.*—If stock may be considered as owned by an individual under either paragraph (2) or (3) it shall be considered as owned by him under paragraph (3).

ART. 404 (a)–1. *Stock ownership.*—For the purpose of determining whether—

(*a*) a corporation is a personal holding company, in so far as such determination is based on the stock ownership requirement specified in section 402 (a) (2) and article 402–3, or

(*b*) amounts received under a personal service contract or from the sale of such a contract constitute personal holding company income in so far as such determination is based on the stock ownership requirement specified in section 403 (e) and paragraph (8) of article 403–1, or

(*c*) compensation for the use of property constitutes personal holding company income in so far as such determination is based on the stock ownership requirement specified in section 403 (f) and paragraph (9) of article 403–1,

stock owned by an individual includes stock constructively owned by him as provided in section 404. For such purpose constructive ownership of stock shall be determined and applied in accordance with the rules provided in section 404 and articles 404 (a)–2 to 404 (a)–7 and article 404 (b)–1. All forms and classes of stock, however denominated, which represent the interests of shareholders, members, or beneficiaries in the corporation shall be taken into consideration.

ART. 404 (a)–2. *Stock not owned by individual.*—In determining the ownership of stock for any of the purposes set forth in article 404 (a)–1, stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. For example, if A and B, two individuals, are the exclusive and equal beneficiaries of a trust or estate, and if such trust or estate owns the entire capital stock of the M Corporation, and if the M Corporation in turn owns the entire capital stock of the N Corporation, then the stock of both the M Corporation and the N Corporation shall be considered as being owned equally by A and B as the individuals owning the beneficial interest therein. See also article 404 (a)–6.

ART. 404 (a)–3. *Family and partnership ownership.*—In determining the ownership of stock for any of the purposes set forth in article 404 (a)–1, an individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For the purposes of such determination the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

The application of the family and partnership rule in determining the ownership of stock for the purpose set forth in (*a*) of article 404 (a)–1 is illustrated by the following example:

Example: The M Corporation at some time during the last half of the taxable year had 1,800 shares of outstanding stock, 450 of which were held by various individuals having no relationship to one another and none of whom were partners, and the remaining 1,350 were held by 51 shareholders as follows:

Relationships	Shares		Shares		Shares		Shares		Shares	
An individual	A	100	B	20	C	20	D	20	E	20
His father	AF	10	BF	10	CF	10	DF	10	EF	10
His wife	AW	10	BW	40	CW	40	DW	40	EW	40
His brother	AB	10	BB	10	CB	10	DB	10	EB	10
His son	AS	10	BS	40	CS	40	DS	40	ES	40
His daughter by former marriage (son's half-sister)	ASHS	10	BSHS	40	CSHS	40	DSHS	40	ESHS	40
His brother's wife	ABW	10	BBW	10	CBW	10	DBW	160	EBW	10
His wife's father	AWF	10	BWF	10	CWF	110	DWF	10	EWF	10
His wife's brother	AWB	10	BWB.	10	CWB	10	DWB	10	EWB	10
His wife's brother's wife	AWBW	10	BWBW	10	CWBW	10	DWBW	10	EWBW	110
Individual's partner	AP	10								

By applying the statutory rule provided in section 404 (a) (2) five individuals own more than 50 percent of the outstanding stock as follows:

A (including AF, AW, AB, AS, ASHS, AP)	160
B (including BF, BW, BB, BS, BSHS)	160
CW (including C, CS, CWF, CWB)	220
DB (including D, DF, DBW)	200
EWB (including EW, EWF, EWBW)	170
Total, or more than 50 percent	910

Individual A represents the obvious case where the head of the family owns the bulk of the family stock and naturally is the head of the group. A's partner owns 10 shares of the stock. Individual B represents the case where he is still head of the group because of the ownership of stock by his immediate family. Individuals C and D represent cases where the individuals fall in groups headed in C's case by his wife and in D's case by his brother because of the preponderance of holdings on the part of relatives by marriage. Individual E represents the case where the preponderant holdings of others eliminate that individual from the group.

The method of applying the family and partnership rule as illustrated in the foregoing example also applies in determining the ownership of stock for the purposes stated in (*b*) and (*c*) of article 404 (a)-1.

ART. 404 (a)-4. *Options.*—In determining the ownership of stock for any of the purposes set forth in article 404 (a)-1, if any person has an option to acquire stock, such stock may be considered as owned by such person. The term "option" as used in this article includes an option to acquire such an option and each one of a series of such options, so that the person who has an option on an option to acquire stock may be considered as the owner of the stock.

ART. 404 (a)-5. *Application of family-partnership and option rules.*—The family and partnership rule provided in section 404 (a) (2) and article 404 (a)-3 and the option rule provided in section 404 (a) (3) and article 404 (a)-4 shall be applied—

(*a*) for the purpose stated in (*a*) of article 404 (a)-1, if, but only if, the effect of such application is to make the corporation a personal holding company, or

(*b*) for the purpose stated in (*b*) of article 404 (a)-1, if, but only if, the effect of such application is to make the amounts received under a personal service contract or from the sale of such a contract personal holding company income, or

(*c*) for the purpose stated in (*c*) of article 404 (a)-1, if, but only if, the effect of such application is to make the compensation for the use of property personal holding company income.

The family and partnership rule and the option rule must be applied independently for each of the purposes stated in article 404 (a)-1.

ART. 404 (a)-6. *Constructive ownership as actual ownership.*—In determining the ownership of stock for any of the purposes set forth in article 404 (a)-1—

(*a*) stock constructively owned by a person by reason of the application of the rule provided in section 404 (a) (1), relating to stock not owned by an individual (see article 404 (a)-2) shall be considered as actually owned by such person for the purpose of again applying such rule or of applying the family and partnership rule provided in section 404 (a) (2) (see article 404 (a)-3) in order to make another person the constructive owner of such stock, and

(*b*) stock constructively owned by a person by reason of the application of the option rule provided in section 404 (a) (3) (see article 404 (a)-4) shall be considered as actually owned by such person for the purpose of applying either the rule provided in section 404 (a) (1), relating to stock not owned by an individual, or the family and partnership rule provided in section 404 (a) (2) in order to make another person the constructive owner of such stock, but

(*c*) stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 404 (a) (2) shall not be considered as actually owned by such individual for the purpose of again applying such rule in order to make another individual the constructive owner of such stock.

The application of this article may be illustrated by the following examples:

Example (1): A's wife, AW, owns all of the stock of the M Corporation, which in turn owns all the stock of the O Corporation. The O Corporation in turn owns all the stock of the P Corporation.

Under the rule provided in section 404 (a) (1), relating to stock not owned by an individual, the stock in the P Corporation owned by the O Corporation is considered to be owned constructively by the M Corporation, the sole shareholder of the O Corporation. Such constructive ownership of the stock of the M Corporation is considered as actual ownership for the purpose of again applying such rule in order to make AW, the sole shareholder of the M Corporation, the constructive owner of the stock of the P Corporation. Similarly, the constructive ownership of the stock by AW is considered as actual ownership for the purpose of applying the family and partnership rule provided in section 404 (a) (2) in order to make A the constructive owner of the stock of the P Corporation, if such application is necessary for any of the purposes set forth in article 404 (a)-1. But the stock thus constructively owned by A may not be considered as actual ownership for the purpose of again applying the family and partnership rule in order to make another member of A's family, for example, A's father, the constructive owner of the stock of the P Corporation.

Example (2): B, an individual, owns all the stock of the R Corporation which has an option to acquire all the stock of the S Corporation, owned by C, an individual, who is not related to B.

Under the option rule provided in section 404 (a) (3) the R Corporation may be considered as owning constructively the stock of the S Corporation owned by C. Such constructive ownership of the stock by the R Corporation is considered as actual ownership for the purpose of applying the rule provided in section 404 (a) (1), relating to stock not owned by an individual, in order to make B, the sole shareholder of the R Corporation, the constructive owner of the stock of the S Corporation. The stock thus constructively owned by B by reason of the application of the rule provided in section 404 (a) (1) likewise is considered as actual ownership for the purpose, if necessary, of applying the family and partnership rule provided in section 404 (a) (2), in order to make another member of B's family, for example, B's wife, BW, the constructive owner of the stock of the S Corporation. However, the family and partnership rule could not again be applied so as to make still another individual the constructive owner of the stock of the S Corporation, that is, the stock constructively owned by BW could not be considered as actually owned by her in order to make BW's father the constructive owner of such stock by a second application of the family and partnership rule.

ART. 404 (a)-7. *Option rule in lieu of family and partnership rule.*—If, in determining the ownership of stock for any of the purposes set forth in article 404 (a)-1 stock may be considered as constructively owned by an individual by an application of both the family-partnership rule provided in section 404 (a)

(2) (see article 404 (a)-3) and the option rule provided in section 404 (a) (3) (see article 404 (a)-4) such stock shall be considered as owned constructively by the individual by reason of the application of the option rule.

The application of this article may be illustrated by the following example:

Example: Two brothers, A and B, each own 10 percent of the stock of the M Corporation, and A's wife, AW, also owns 10 percent of the stock of such corporation. AW's husband, A, has an option to acquire the stock owned by her at any time. It becomes necessary, for one of the purposes stated in article 404 (a)-1, to determine the stock ownership of B in the M Corporation.

If the family and partnership rule were the only rule that applied in the case, B would be considered, under that rule, as owning 20 percent of the stock of the M Corporation, namely, his own stock plus the stock owned by his brother. In that event, B could not be considered as owning the stock held by AW since (1) AW is not a member of B's family and (2) the constructive ownership of such stock by A through the application of the family and partnership rule in his case is not considered as actual ownership so as to make B the constructive owner by a second application of the same rule with respect to the ownership of the stock. (See article 404 (a)-6.)

However, there is more than the family and partnership rule involved in this example. As the holder of an option upon the stock, A may be considered the constructive owner of his wife's stock by the application of the option rule and without reference to the family relationship between A and AW. If A is considered as owning the stock of his wife by application of the option rule, then under article 404 (a)-6, such constructive ownership by A is regarded as actual ownership for the purpose of applying the family and partnership rule so as to make another member of A's family, for example B, the constructive owner of the stock. Hence, since A may be considered as owning his wife's stock by applying both the family-partnership rule and the option rule, the provisions of section 404 (a) (6) apply and accordingly A must be considered the constructive owner of his wife's stock under the option rule rather than the family-partnership rule. B thus becomes the constructive owner of 30 percent of the stock of the M Corporation, namely, his own 10 percent, A's 10 percent, and AW's 10 percent constructively owned by A as the holder of an option on the stock.

[SEC. 404. *Stock ownership.*]

(b) *Convertible securities.*—Outstanding securities convertible into stock (whether or not convertible during the taxable year) shall be considered as outstanding stock—

(1) For the purpose of the stock ownership requirement provided in section 402 (a) (2), but only if the effect of the inclusion of all such securities is to make the corporation a personal holding company;

(2) For the purpose of section 403 (e) (relating to personal service contracts), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such subsection as personal holding company income; and

(3) For the purpose of section 403 (f) (relating to the use of property by shareholders), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such subsection as personal holding company income.

The requirement in paragraphs (1), (2), and (3) that all convertible securities must be included if any are to be included shall be subject to the exception that, where some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be included although the others are not included, but no convertible securities shall be included unless all outstanding securities having a prior conversion date are also included.

ART. 404 (b)-1. *Convertible securities.*—Under section 404 (b), outstanding securities of a corporation, such as bonds, debentures, or other corporate obligations, convertible into stock of the corporation (whether or not convertible during the taxable year) shall be considered as outstanding stock of the corporation for the purpose of the stock ownership requirement provided in section 402 (a) (2), but only if the effect of such consideration is to make the corporation a personal holding company. Such convertible securities shall be considered as outstanding stock for the purpose of section 403 (e), relating to amounts received under personal service contracts, or of section 403 (f), relating to compensation for the use of property, but only if the effect of such consideration is to make the amounts therein referred to includible under such sections as personal holding company income. The consideration of convertible securities as outstanding stock is subject to the exception that, if some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be considered as outstanding stock although the others are not so considered, but no convertible securities shall be considered as outstanding stock unless all outstanding securities having a prior conversion date are also so considered. For example, if outstanding securities are convertible in 1938, 1939, and 1940, those convertible in 1938 can be properly considered as outstanding stock without so considering those convertible in 1939 or 1940, and those convertible in 1938 and 1939 can be properly considered as outstanding stock without so considering those convertible in 1940. However, the securities convertible in 1939 could not be properly considered as outstanding stock without so considering those convertible in 1938 and the securities convertible in 1940 could not be properly considered as outstanding stock without so considering those convertible in 1938 and 1939.

SEC. 405. *Undistributed title IA net income.*—For the purposes of this title the term "undistributed Title IA net income" means the Title IA net income (as defined in section 406) minus—

(a) The amount of the dividends paid credit provided in section 27 (a) without the benefit of paragraphs (3) and (4) thereof (computed without its reduction, under section 27 (b) (1), by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations); but, in the computation of the dividends paid credit for the purposes of this title, the amount allowed under subsection (c) of this section in the computation of the tax under this title for any preceding taxable year shall be considered as a dividend paid in such preceding taxable year and not in the year of distribution;

(b) Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness;

(c) Dividends paid after the close of the taxable year and before the 15th day of the third month following the close of the taxable year, if claimed under this subsection in the return, but only to the extent to which such dividends are includible, for the purposes of Title I, in the computation of the basic surtax credit for the year of distribution; but the amount allowed under this subsection shall not exceed either:

(1) The accumulated earnings and profits as of the close of the taxable year; or

(2) The undistributed Title IA net income for the taxable year computed without regard to this subsection; or

(3) 10 per centum of the sum of—

(A) The dividends paid during the taxable year (reduced by the amount allowed under this subsection in the computation of the tax under this title for the taxable year preceding the taxable year); and

(B) The consent dividends credit for the taxable year.

ART. 405-1. *Undistributed Title IA net income.*—The term "undistributed Title IA net income" means the Title IA net income (as defined in section 406 and article 406-1) minus (A) the amount of the dividends paid credit provided in section 27 (a) without the benefit of paragraphs (3), relating to the deficit credit, and (4) relating to the debt credit, thereof (computed without its reduction, under section 27 (b) (1), by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and government corporations), (B) amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and the terms of such indebtedness (see article 405-2) and (C) dividends paid after the close of the taxable year and before the fifteenth day of the third month thereafter, if claimed under subsection (c) of section 405 in the return, but only to the extent and subject to the limitations contained in that subsection. In computing the dividends paid credit for the purposes of Title IA, the amount allowed under subsection (c) in the computation of the tax under Title IA for any preceding taxable year is considered a dividend paid in such preceding taxable year and not in the year of distribution.

ART. 405-2. *Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934*—(*a*) *Indebtedness.*—The term "indebtedness" means an obligation, absolute and not contingent, to pay, on demand or within a given time, in cash or other medium, a fixed amount. The term "indebtedness" does not include the obligation of a corporation on its capital stock.

The indebtedness must have been incurred (or, if incurred by assumption, assumed) by the taxpayer prior to January 1, 1934. An indebtedness evidenced by bonds, notes or other obligations issued by a corporation is ordinarily incurred as of the date such obligations are issued and the amount of such indebtedness is the amount represented by the face value of the obligations. In the case of renewal or other changes in the form of an indebtedness, so long as the relationship of debtor and creditor continues between the taxpayer and his creditor, the giving of a new promise to pay by the taxpayer will not have the effect of changing the date the indebtedness was incurred.

(*b*) *Amounts used or irrevocably set aside.*—The deduction is allowable, in any taxable year, only for amounts used or *irrevocably* set aside in that year. The use or irrevocable setting aside must be to effect the extinguishment or discharge of indebtedness. Since, therefore, in the case of renewal and other changes in the form of an indebtedness, the relationship of debtor and creditor continues between the taxpayer and his creditor, the mere giving of a new promise to pay by the taxpayer will not result in an allowable deduction. If amounts are set aside in one year, no deduction is allowable for such amounts for a later year in which actually paid. As long as all other conditions are satisfied, the aggregate amount allowable as a deduction for any taxable year includes all amounts (from whatever source) used and, as well, all amounts (from whatever source) *irrevocably* set aside, irrespective of whether in cash or other medium. Double deductions were not permitted.

(*c*) *Reasonableness of the amounts with reference to the size and terms of the indebtedness.*—The reasonableness of the amounts used or *irrevocably* set aside must be determined by reference to the size and terms of the particular indebtedness. Hence, all the facts and circumstances with respect to the nature, scope, conditions, amount, maturity, and other terms of the particular indebtedness must be shown in each case.

Ordinarily an amount used to pay or retire an indebtedness, in whole or in part, at or prior to the maturity and in accordance with the terms thereof will be considered reasonable, and may be allowable as a deduction for the year in which so used, if no adjustment is required by reason of an amount set aside in a prior year for payment or retirement of the same indebtedness.

All amounts *irrevocably* set aside for the payment or retirement of an indebtedness in accordance with and pursuant to the terms of the obligation, for example, the annual contribution *to trustees* required by the provisions of a mandatory sinking fund agreement, will be considered as complying with the statutory requirement of reasonableness. To be considered reasonable it is not necessary that the plan of retirement provide for a retroactive setting aside of amounts for years prior to that in which the plan is adopted. However, if a voluntary plan was adopted prior to 1934, no adjustment is allowable in respect of the amounts set aside in the years prior to 1934.

(*d*) *General.*—The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, the taxpayer must furnish the information required by the return, and such other information as the Commissioner may require in substantiation of the deduction claimed.

SEC. 406. *Title IA net income.*—For the purposes of this title the term "Title IA net income" means the net income with the following adjustments:

(*a*) *Additional deductions.*—There shall be allowed as deductions—

(1) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction under section 23; but not including the tax imposed by section 102, section 401, or a section of a prior income-tax law corresponding to either of such sections.

(2) In lieu of the deduction allowed by section 23 (q), contributions or gifts payment of which is made within the taxable year to or for the use of donees described in section 23 (q) for the purposes therein specified, to an amount which does not exceed 15 per centum of the taxpayer's net income, computed without the benefit of this paragraph and section 23 (q), and without the deduction of the amount disallowed under subsection (b) of this section.

(3) In the case of a corporation organized prior to January 1, 1936, to take over the assets and liabilities of the estate of a decedent, amounts paid in liquidation of any liability of the corporation based on the liability of the decedent to make contributions or gifts to or for the use of donees described in section 23 (o) for the purposes therein specified, to the extent such liability of the decedent existed prior to January 1, 1934. No deduction shall be allowed under paragraph (2) of this subsection for a taxable year for which a deduction is allowed under this paragraph.

(*b*) *Deductions not allowed.*—The aggregate of the deductions allowed under section 23 (a), relating to expenses, and section 23 (l), relating to depreciation, which are allocable to the operation and maintenance of property owned or operated by the corporation, shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established (under regulations prescribed by the Commissioner with the approval of the Secretary) to the satisfaction of the Commissioner:

(1) That the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

(2) That the property was held in the course of a business carried on bona fide for profit; and

(3) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

ART. 406-1. *Title IA net income.*—The term "Title IA net income" means, in the case of a domestic corporation, the gross income as defined in section 22 less the deductions provided in section 23 subject to the qualifications, limitations, and exceptions provided in section 406. In the case of a foreign corporation, whether resident or nonresident, which files or causes a return to be filed, the "Title IA net income" means the net income from sources within the United States (gross income from sources within the United States as defined in section 119 and the regulations thereunder less statutory deductions) subject to the qualifications, limitations and exceptions provided in section 406. In the case of a foreign corporation, whether resident or nonresident, which files no return the "Title IA net income" means the gross income from sources within the United States as defined in section 119 and the regulations thereunder less the deductions enumerated in section 406 (a) but without the benefit of any deductions under Title I (see section 233).

The "Title IA net income" includes interest upon obligations of the United States and obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States, except as provided in section 22 (b) (4). The "Title IA net income" does not include interest on obligations of States or Territories of the United States or any political subdivision thereof or of the District of Columbia or of the possessions of the United States.

The foreign tax credit permitted by section 131 with respect to the taxes imposed by Title I is not allowed with respect to the surtax imposed by section 401. However, the deduction of foreign taxes under section 23 (c) is permitted for the purposes of the surtax even if for the purposes of the corporate tax imposed by Title I a credit for such taxes is taken.

In addition to the qualifications, limitations, and exceptions provided in section 406 (a), under section 406 (b) the aggregate of the deductions allowed under section 23 (a), relating to expenses, and section 23 (l), relating to depreciation, which are allocable to the operation and maintenance of property owned or operated by the company shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner:

(1) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(2) That the property was held in the course of a business carried on bona fide for profit; and

(3) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If, in computing its Title IA net income, a personal holding company claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, it shall attach to its income tax return a statement setting forth its claim for allowance of the additional deductions together with a complete statement of the facts and circumstances pertinent to its claim and the arguments on which it relies. Such statement shall set forth:

(*a*) A description of the property;

(*b*) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(*c*) The name and address of the person from whom acquired and the date thereof;

(*d*) The name and address of the person to whom leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(*e*) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;

(*f*) Evidence that the rent or other compensation was the highest obtainable and, if none was received, a statement of the reasons therefor;

(*g*) A copy of the contract, lease or rental agreement;

(*h*) The purpose for which the property was used;

(*i*) The business carried on by the corporation with respect to which the property was held and the gross income, expenses and net income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(*j*) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(*k*) Any other information pertinent to the taxpayer's claim.

ART. 406-2. *Illustration of computation of Title IA net income, undistributed Title IA net income, and surtax.*—The method of computation of the Title IA net income, the undistributed Title IA net income, and the surtax under Title IA may be illustrated as follows:

The following facts exist with respect to the O Corporation, a personal holding company which is on the cash receipts and disbursements basis, for the calendar year 1938:

The net income, as computed under Title I, amounts to $190,000.

Federal income tax for the year 1937 paid March 15, 1938, aggregates $17,500. This amount includes the surtax under section 14 of the Revenue Act of 1936 but does not include excess-profits tax imposed by section 106 of the Revenue Act of 1935, surtax imposed by section 102 of the Revenue Act of 1936, or section 351 of the latter Act as amended by the Revenue Act of 1937, or a section of a prior income-tax law corresponding to either of such sections 102 or 351.

Contributions or gifts payment of which is made to or for the use of donees described in section 23 (q) for the purposes therein specified amount to $35,000, of which $10,000 is deducted in arriving at the net income under Title I.

Rent in the amount of $10,000 was received from the principal shareholder of the corporation for the use of a country estate which had been previously acquired from such shareholder in exchange for its capital stock. The expenses of the corporation allocable to the maintenance and operation of the country estate amount to $30,000. The yearly depreciation on the depreciable property of the estate amounts to $5,000. The corporation has not established its right to claim the entire amount of the expenses and depreciation applicable to the estate as provided in section 406 (b) and article 406-1.

Dividends paid by the corporation to its shareholders during the taxable year which are allowable as a credit under section 27 (a) amount to $125,000.

The amount used during the year to pay indebtedness incurred by the corporation prior to January 1, 1934, is $31,750.

On March 1, 1939, the corporation paid its shareholders a taxable dividend of $15,000 and in its return, on Form 1120H, claimed a deduction for that amount under section 405 (c). Its accumulated earnings and profits as of the close of the taxable year 1938 were more than $15,000.

The Title IA net income, the undistributed Title IA net income, and the surtax are computed as follows:

Net income under Title I		$190,000
Add:		
Contributions deductible in computing net income under section 21		10,000
Aggregate of expenses and depreciation relating to the country estate in excess of the income derived therefrom		25,000
Net income computed without the benefit of a deduction for contributions and without the benefit of the amount disallowed under section 406 (b)		225,000
Less:		
Federal income taxes	$17,500	
Contributions deductible under section 406 (a) (2) (15 percent of $225,000)	33,750	
		$51,250
Title IA net income		173,750
Less:		
Dividends paid credit	$125,000	
Amount used to pay indebtedness	31,750	
		156,750
Undistributed Title IA net income (before applying section 405 (c))		17,000
Dividends paid March 1, 1939 (subject to limitation in section 405 (c) (3))		12,500
Undistributed Title IA net income		4,500
Amount taxable at 65 percent (not in excess of $2,000)		2,000
Amount taxable at 75 percent ($4,500 minus $2,000)		2,500
Surtax on $2,000 at 65 percent		1,300
Surtax on $2,500 at 75 percent		1,875
Total surtax		3,175

SEC. 407. *Deficiency dividends—Credits and refunds.*—(*a*) *Credit against unpaid deficiency.*—If the amount of a deficiency with respect to the tax imposed by this title for any taxable year has been established—

(1) by a decision of the Board of Tax Appeals which has become final; or

(2) by a closing agreement made under section 606 of the Revenue Act of 1928, as amended; or

(3) by a final judgment in a suit to which the United States is a party;

then a deficiency dividend credit shall be allowed against the amount of the deficiency so established and all interest, additional amounts, and additions to the tax provided by law not paid on or before the date when claim for a deficiency dividend credit is filed under subsection (d). The amount of such credit shall be 65 per centum of the amount of deficiency dividends, as defined in subsection (c), not in excess of $2,000, plus 75 per centum of the amount of such dividends in excess of $2,000; but such credit shall not exceed the portion of the deficiency so established which is not paid on or before the date of the closing agreement, or the date the decision of the Board or the judgment becomes final, as the case may be. Such credit shall be allowed as of the date the claim for deficiency dividend credit is filed.

(*b*) *Credit or refund of deficiency paid.*—When the Commissioner has determined that there is a deficiency with respect to the tax imposed by this title and the corporation has paid any portion of such asserted deficiency and it has been established—

(1) by a decision of the Board of Tax Appeals which has become final; or

(2) by a closing agreement made under section 606 of the Revenue Act of 1928, as amended; or

(3) by a final judgment in a suit against the United States for refund—

(A) if such suit is brought within six months after the corporation became entitled to bring suit, and

(B) if claim for refund was filed within six months after the payment of such amount;

that any portion of the amount so paid was the whole or a part of a deficiency at the time when paid, then there shall be credited or refunded to the corporation an amount equal to 65 per centum of the amount of deficiency dividends not in excess of $2,000, plus 75 per centum of the amount of such dividends in excess of $2,000, but such credit or refund shall not exceed the portion so paid by the corporation. Such credit or refund shall be made as provided in section

322 but without regard to subsection (b) or subsection (c) thereof. No interest shall be allowed on such credit or refund. No credit or refund shall be made under this subsection with respect to any amount of tax paid after the date of the closing agreement, or the date the decision of the Board or the judgment becomes final, as the case may be.

(c) *Deficiency dividends.*—(1) *Definition.*—For the purpose of this title, the term "deficiency dividends" means the amount of the dividends paid, on or after the date of the closing agreement or on or after the date the decision of the Board or the judgment becomes final, as the case may be, and prior to filing claim under subsection (d), which are includible, for the purposes of Title I, in the computation of the basic surtax credit for the year of distribution. No dividends shall be considered as deficiency dividends for the purposes of allowance of credit under subsection (a) unless (under regulations prescribed by the Commissioner with the approval of the Secretary) the corporation files, within thirty days after the date of the closing agreement, or the date upon which the decision of the Board or judgment becomes final, as the case may be, notification (which specifies the amount of the credit intended to be claimed) of its intention to have the dividends so considered.

(2) *Effect on dividends paid credit.*—(A) *For taxable year in which paid.*—Deficiency dividends paid in any taxable year (to the extent of the portion thereof with respect to which the credit under subsection (a), or the credit or refund under subsection (b), or both, are allowed) shall be subtracted from the basic surtax credit for such year, but only for the purpose of computing the tax under this title for such year and succeeding years.

(B) *For prior taxable year.*—Deficiency dividends paid in any taxable year (to the extent of the portion thereof with respect to which the credit under subsection (a), or the credit or refund under subsection (b), or both, are allowed) shall not be allowed under section 405 (c) in the computation of the tax under this title for any taxable year preceding the taxable year in which paid.

(d) *Claim required.*—No deficiency dividends credit shall be allowed under subsection (a) and no credit or refund shall be made under subsection (b) unless (under regulations prescribed by the Commissioner with the approval of the Secretary) claim therefor is filed within sixty days after the date of the closing agreement, or the date upon which the decision of the Board or judgment becomes final, as the case may be.

(e) *Suspension of statute of limitations and stay of collection.*—(1) *Suspension of running of statute.*—If the corporation files a notification, as provided in subsection (c), to have dividends considered as deficiency dividends, the running of the statute of limitations provided in section 275 or 276 on the making of assessments and the bringing of distraint or a proceeding in court for collection, in respect of the deficiency and all interest, additional amounts, and additions to the tax provided by law, shall be suspended for a period of two years after the date of the filing of such notification.

(2) *Stay of collection.*—In the case of any deficiency with respect to the tax imposed by this title established as provided in subsection (a)—

(A) The collection of the deficiency and all interest, additional amounts, and additions to the tax provided for by law shall, except in cases of jeopardy, be stayed until the expiration of thirty days after the date of the closing agreement, or the date upon which the decision of the Board or judgment becomes final, as the case may be.

(B) If notification has been filed as provided in subsection (c) the collection of such part of the deficiency as is not in excess of either the credit allowable under subsection (a) or the amount which in the notification is specified as intended to be claimed as credit shall, except in cases of jeopardy, be stayed until the expiration of sixty days after the date of the closing agreement, or the date upon which the decision of the Board or judgment becomes final, as the case may be.

(C) If claim for deficiency dividend credit is filed under subsection (d), the collection of such part of the deficiency as is not in excess of either the credit allowable under subsection (a) or the amount claimed, shall be stayed until the date the claim for credit is disallowed (in whole or in part), and if disallowed in part collection shall be made only of the part disallowed.

No distraint or proceeding in court shall be begun for the collection of an amount the collection of which is stayed under subparagraph (A), (B), or (C), during the period for which the collection of such amount is stayed.

(f) *Credit or refund denied if fraud, etc.*—No deficiency dividend credit shall be allowed under subsection (a) and no credit or refund shall be made under subsection (b) if the closing agreement, decision of the Board, or judgment contains a finding that any part of the deficiency is due to fraud with intent to evade tax, or to failure to file the return under this title within the time prescribed by law or prescribed by the Commissioner in pursuance of law, unless it is shown that such failure to file is due to reasonable cause and not due to willful neglect.

ART. 407–1. *Purpose and scope of deficiency dividend credit.*—Section 407 provides a method under which, by virtue of dividend distributions, a corporation may, under certain conditions (see article 407–3), be relieved from the payment of a deficiency in the surtax imposed by Title IA with respect to any taxable year beginning after December 31, 1937, or, if any portion of such deficiency has been paid, may be entitled, under certain conditions (see article 407–4), to a credit or refund of such portion. The deficiency must be established in the manner specified in section 407 (a) (1), (2), or (3) or section 407 (b) (1), (2), or (3) and the dividends must be paid on the date so established or within 60 days thereafter. For what constitutes payment of a dividend, see article 27 (b)–2.

The benefit of section 407 is not extended to the satisfaction of any interest, additional amounts, or additions to the tax provided by law with respect to the deficiency and such amounts remain payable as if that section had not been enacted. The benefit is denied to any deficiency attributable, in whole or in part, to fraud with intent to evade the tax, or to a failure to file a timely return without reasonable cause for such failure. See section 407 (f).

ART. 407–2. *Date when decision by Board or court becomes final.*—The date upon which a decision by the Board of Tax Appeals becomes final is prescribed in section 1005 of the Revenue Act of 1926, as amended. See paragraph 16 of the Appendix to these regulations.

The date upon which a judgment of a court becomes final must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken, within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

ART. 407–3. *Credit against unpaid deficiency*—(a) *General.*—If the amount of a deficiency with respect to the tax imposed by Title IA for any taxable year beginning after December 31, 1937, has been established as provided in section 407 (a) (1), (2), or (3), the corporation, under certain circumstances, is entitled to a deficiency dividends credit which, though it may not exceed the amount of the deficiency, is to be applied against the amount of such deficiency and all interest, additional amounts, and additions to the tax provided by law not paid on or before the date when the claim for a deficiency dividends credit is filed under section 407 (d). The amount of the deficiency dividends credit is 65 percent of the amount of "deficiency dividends" (as defined in section 407 (c)) not in excess of $2,000 plus 75 percent of the amount of such dividends in excess of $2,000, and the allowance of the credit is subject to the following conditions, qualifications and limitations:

(1) The corporation is required under section 407 (c), within 30 days after the date of the closing agreement or the date upon which the decision of the Board or the judgment becomes final, to file a notice of its intention to claim a deficiency dividends credit, which notice shall specify the amount of the credit intended to be claimed;

(2) The corporation is required under section 407 (d), within 60 days after the date of the closing agreement or the date upon which the decision of the Board or judgment becomes final, to file a claim with respect to the credit for deficiency dividends;

(3) The deficiency dividends are required under section 407 (c) to be paid prior to the filing of the claim for a deficiency dividends credit and such dividends must be of such a nature as to constitute taxable dividends in the hands of such of the shareholders as are subject to taxation under Title I for the year in which paid (see section 27 (i), and must be nonpreferential (see section 27 (h)); and

(4) Under section 407 (a) the deficiency dividends credit shall not exceed the portion of the deficiency (not counting the interest, additional amounts, and additions to the tax, provided by law) which is not paid on or before the date of the closing agreement, or the date the decision of the Board or the judgment becomes final, as the case may be.

(b) *Form of notification.*—The notice of intention to have dividends considered as deficiency dividends for the purposes of the allowance of credit under section

407 (a) shall be made, under oath or affirmation, on Form 975, copies of which, upon request, may be procured from any collector.

(c) *Contents of notification.*—The notification shall, in accordance with the provisions of this article and the instructions on the form, set forth the following information:

(1) The name and address of the corporation;

(2) The place and date of incorporation;

(3) The amount of the unpaid deficiency with respect to the tax imposed by Title IA; how it was established (closing agreement, Board decision or court judgment); the date thereof and the taxable year or years involved;

(4) The amount of the credit intended to be claimed as a deficiency dividends credit; and

(5) Such other information as may be required by the notification form.

(d) *Time and place of filing notification.*—The notification required by section 407 (c) (1) and this article shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, within 30 days after the date of the closing agreement, or the date upon which the decision of the Board or judgment becomes final, as the case may be.

(e) *Claim for deficiency dividends credit.*—For claims for deficiency dividends credits, see article 407-5.

ART. 407-4. *Credit or refund of deficiency paid.*—If the Commissioner has determined that there is a deficiency with respect to the tax imposed by Title IA for any taxable year beginning after December 31, 1937, and the corporation has paid any portion of such asserted deficiency, the corporation, under certain circumstances, is entitled to a credit or refund of such deficiency. The amount of the credit or refund is 65 percent of the amount of "deficiency dividends" (as defined in section 407 (c)) not in excess of $2,000, plus 75 percent of the amount of such dividends in excess of $2,000, and the allowance of the credit or refund is subject to the following conditions, qualifications and limitations:

(1) It must be established that the amount for which credit or refund is sought was the whole or a part of a deficiency at the time when paid, and such fact must be established as provided in section 407 (b) (1), (2) or (3);

(2) The corporation is required under section 407 (d), within 60 days after the date of the closing agreement or the date upon which the decision of the Board or the judgment becomes final to file a claim for credit or refund;

(3) The "deficiency dividends" are required under section 407 (c), to be paid prior to the filing of the claim for credit or refund and such dividends must be of such a nature as to constitue taxable dividends in the hands of such of the shareholders as are subject to taxation under Title I for the year in which paid (see section 27 (i)), and must be nonpreferential (see section 27 (h));

(4) The credit or refund shall not exceed the portion of the deficiency (not counting the interest, additional amounts, and additions to the tax, provided by law) which was paid by the corporation;

(5) The credit or refund shall be made as provided in section 322, but without regard to section 322 (b) (relating to the limitations on the allowance of refunds or credits), or section 322 (c) (relating to the effect of petitions to the Board on refunds or credits);

(6) No credit or refund shall be made under section 407 (b) with respect to any amount of tax paid after the date of the closing agreement, or the date the decision of the Board or the judgment becomes final, as the case may be; and

(7) No interest shall be allowed on the credit or refund.

ART. 407-5. *Claim for deficiency dividends credit or credit or refund*—(a) *General.*—A claim for a deficiency dividends credit under section 407 (a), relating to credit against unpaid deficiency, and under section 407 (b), relating to credit or refund of deficiency paid, must be filed within 60 days after the date of the closing agreement, or the date upon which the decision of the Board or judgment becomes final, as the case may be.

(b) *Form of claim.*—The claim for a deficiency dividends credit, or credit or refund, shall be made in duplicate, under oath or affirmation, on Form 976, copies of which, upon request, may be procured from any collector.

(c) *Contents of claim.*—There shall be attached to and made a part of the claim a certified copy of the resolution of the board of directors, or other authority, authorizing the payment of the dividend with respect to which the claim is filed. In addition the claim shall, in accordance with the provisions of this article and the instructions on the form, set forth the following information:

(1) The name and address of the corporation;

(2) The place and date of incorporation;

(3) The amount of the deficiency determined with respect to the tax imposed by Title IA and the taxable year or years involved; the amount of the unpaid deficiency or, if the deficiency has been paid in whole or in part, the date of payment and the amount thereof; a statement as to how the deficiency was established, if unpaid, or if paid in whole or in part, how it was established that any portion of the amount paid was a deficiency at the time when paid and in either case whether it was by closing agreement, Board decision or court judgment and the date thereof; if established by a final judgment in a suit against the United States for refund, the date of payment of the deficiency, the date claim for refund was filed and the date the suit was brought; if established by a Board decision or court judgment a copy thereof shall be attached, together with an explanation of how the decision or judgment became final;

(4) The amount and date of payment of the dividend with respect to which the claim for deficiency dividends credit, or credit or refund, is filed;

(5) A statement setting forth the various classes of stock outstanding, the name and address of each shareholder, the class and number of shares held by each on the date of payment of the dividend with respect to which the claim is filed, and the amount of such dividend paid to each shareholder;

(6) The amount claimed as a deficiency dividends credit; and

(7) Such other information as may be required by the claim form.

(d) *Time and place of filing claim.*—The claim required by section 407 (d) and this article shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, within 60 days after the date of the closing agreement, or the date upon which the decision of the Board or judgment becomes final, as the case may be.

ART. 407-6. *Effect of deficiency dividends on dividends paid credit.*—No duplication of credit allowances with respect to any "deficiency dividends" is permitted. If a corporation claims and receives the benefit of the provisions of section 407 based upon a distribution of "deficiency dividends," that distribution does not become a part of the basic surtax credit for the purposes of Title IA; nor is it made the basis of the 2½-month carry-back credit provided for in section 405 (c).

ART. 407-7. *Suspension of statute of limitations and stay of collection*—(a) *Suspension of running of statute.*—If a corporation files a notification of its intent to have certain dividends considered as "deficiency dividends" as provided in section 407 (c), then the running of the statute of limitations upon the assessment and collection of the established deficiency and all interest, additional amounts, and additions to the tax provided by law, is suspended for a period of two years after the date of the filing of such notification.

(b) *Stay of collection.*—The Act provides that, except in case of jeopardy, the collection of the established deficiency and all interest, additional amounts, and additions to the tax provided by law, is stayed for a period of 30 days subsequent to the final determination of the amount thereof. If within such 30-day period the corporation files with the Commissioner the prescribed notification of intention to seek the benefit of section

407, the collection of the established deficiency, to the extent of the amount of the credit specified by the corporation in such notification if not in excess of the amount allowable under section 407 (a), is, except in cases of jeopardy, stayed for a period of 60 days subsequent to the final determination of the amount thereof. The filing of a claim for a deficiency dividends credit under section 407 (d) effects a further stay of collection of that portion of the established deficiency covered by the claim if not in excess of the amount allowable under section 407 (a), until the date the claim is disallowed (in whole or in part) by the Commissioner. The Act further provides that where collection has been stayed as above indicated no distraint or proceeding in court shall be begun for the collection of the amount stayed during the period for which it is stayed. The Commissioner, notwithstanding the provisions of section 272 (b), may refrain from assessing the Title IA deficiency (plus interest, additional amounts, and additions to the tax) until the claim for the deficiency dividends credit is disposed of. After such claim is allowed or rejected, either in whole or in part, the entire amount of the deficiency (plus interest, additional amounts, and additions to the tax) will be assessed, if not already assessed. The amount of the claim for the deficiency dividends credit to the extent allowed will be credited against the amount so assessed, and the remainder of the amount assessed will be collected in the usual manner.

SEC. 408. *Meaning of terms used.*—The terms used in this title shall have the same meaning as when used in Title I.

SEC. 409. *Administrative provisions.*—All provisions of law (including penalties) applicable in respect of the taxes imposed by Title I, shall insofar as not inconsistent with this title, be applicable in respect of the tax imposed by this title, except that the provisions of section 131 shall not be applicable.

ART. 409-1. *Return and payment of tax.*—A separate return is required for the surtax imposed by section 401. Such returns shall be made on Form 1120H. In the case of a personal holding company which is a domestic corporation, the return is required to be made within the time provided by section 53 and in the case of a foreign corporation within the time provided in section 235. The tax shown by the corporation on its return must be paid in the case of a domestic corporation within the time provided in section 56 and in the case of a foreign corporation within the time provided in section 236. The same provisions of law relating to the period of limitations for assessment and collection which govern the taxes imposed by Title I also apply to the surtax imposed under Title IA. However, since the surtax imposed under Title IA is a distinct and separate tax from those imposed under Title I, the making of a return under Title I will not start the period of limitations for assessment of the surtax imposed under Title IA. If the corporation subject to section 401 fails to file a return the tax may be assessed at any time. If the Commissioner finds a deficiency in respect of the tax imposed by section 401 of Title IA, he is required to follow the same procedure which applies to deficiencies in income tax under Title I. The penalties applicable to the income taxes imposed under Title I, as well as the provisions of Title I relating to interest and additions to the tax, also apply to the surtax imposed by section 401. The administrative provisions applicable to the surtax imposed by section 401 are not confined to those contained in Title I but embrace all administrative provisions of law which have any application to income taxes.

ART. 409-2. *Determination of tax, assessment, collection.*—The determination, assessment and collection of the tax imposed by section 401 and the examination of returns and claims in connection therewith, will be made under such procedure as may be prescribed from time to time by the Commissioner.

SEC. 410. *Improper accumulation of surplus.*—For surtax on corporations which accumulate surplus to avoid surtax on shareholders, see section 102.

SEC. 411. *Foreign personal holding companies.*—For provisions relating to foreign personal holding companies and their shareholders, see Supplement P of Title I.

CHAPTER XXXVIII

Title VI—General Provisions

SEC. 901. *Definitions.*—(a) When used in this Act—

(1) The term "person" means an individual, a trust or estate, a partnership, or a corporation.

(2) The term "corporation" includes associations, joint-stock companies, and insurance companies.

(3) The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operations, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

(4) The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State or Territory.

(5) The term "foreign" when applied to a corporation or partnership means a corporation or partnership which is not domestic.

(6) The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.

(7) The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 143 or 144.

(8) The term "stock" includes the share in an association, joint-stock company, or insurance company.

(9) The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

(10) The term "United States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.

(11) The term "Secretary" means the Secretary of the Treasury.

(12) The term "Commissioner" means the Commissioner of Internal Revenue.

(13) The term "collector" means collector of internal revenue.

(14) The term "taxpayer" means any person subject to a tax imposed by this Act.

(b) The terms "includes" and "including" when used in a definition contained in this Act shall not be deemed to exclude other things otherwise within the meaning of the term defined.

ART. 901-1. *Classification of taxables.*—For the purpose of taxation the Act makes its own classification and prescribes its own standards of classification. Local law is of no importance in this connection. Thus a trust may be classed as a trust or as an association (and, therefore, as a corporation), depending upon its nature or its activities. (See article 901-3.) The term "partnership" is not limited to the common law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships. (See article 901-4.) The term "corporation" is not limited to the artificial entity usually known as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint-stock company, an insurance company, and certain kinds of partnerships. (See articles 901-2 and 901-4.) The definitions, terms, and classifications, as set forth in section 901, shall have the same respective meaning and scope in these regulations.

ART. 901-2. *Association.*—The term "association" is not used in the Act in any narrow or technical sense. It includes any organization, created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. It includes a voluntary association, a joint-stock association or company, a "business" trust, a "Massachusetts" trust, a "common law" trust, an "investment" trust (whether of the fixed or the management type), an interinsurance exchange operating through an attorney in fact, a partnership association, and any other type of organization (by whatever name known) which is not, within the meaning of the Act, a trust or an estate, or a partnership. If the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association.

ART. 901-3. *Association distinguished from trust.*—The term "trust," as used in the Act, refers to an ordinary trust, namely, one created by will or by declaration of the trustees or the grantor, the trustees of which take title to the property for the purpose of protecting or conserving it as customarily required under the ordinary rules applied in chancery and probate courts. The beneficiaries of such a trust generally do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. Even though the beneficiaries do create such a trust, it is ordinarily done to conserve the trust property without undertaking any activity not strictly necessary to the attainment of that object.

As distinguished from the ordinary trust described in the preceding paragraph is an arrangement whereby the legal title to the property is conveyed to trustees (or a trustee) who, under a declaration or agreement of trust, hold and manage the property with a view to income or profit for the benefit of beneficiaries. Such an arrangement is designed (whether expressly or otherwise) to afford a medium whereby an income or profit-seeking activity may be carried on through a substitute for an organization such as a voluntary association or a joint-stock company or a corporation, thus obtaining the advantages of those forms of organization without their disadvantages. The nature and purpose of a cooperative undertaking will differentiate it from an ordinary trust. The purpose will not be considered narrower than that which is formally set forth in the instrument under which the activities of the trust are conducted.

If a trust is an undertaking or arrangement conducted for income or profit, the capital or property of the trust being supplied by the beneficiaries, and if the trustees or other designated persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the beneficiaries are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classified by the Act as a corporation. However, the fact that the capital or property of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association.

By means of such a trust the disadvantages of an ordinary partnership are avoided, and the trust form affords the advantages of unity of management and continuity of existence which are characteristic of both associations and corporations. This trust form also affords the advantages of capacity, as a unit to acquire, hold, and dispose of property and the ability to sue and be sued by strangers or members, which are characteristic of a corporation; and also frequently affords the limitation of liability and other advantages characteristic of a corporation. These advantages which the trust form provides are frequently referred to as resemblance to the general form, mode of procedure, or effectiveness in action, of an association or a corporation, or as "quasi-corporate form." The effectiveness in action in the case of a trust or of a corporation does not depend upon technical arrangements or devices such as the appointment or election of a president, secretary, treasurer, or other "officer," the use of a "seal," the issuance of certificates to the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a "charter" or "by-laws," the existence of "control" by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing them should be treated as a corporation, but they are not essential to such classification, for the fundamental benefits enjoyed by a corporation, as outlined above, are attained, in the case of a trust, by the use of the trust form *itself*. The Act disregards the technical distinction between a trust agreement (or declaration) and ordinary articles of association or a corporate charter, and all other differences of detail. It treats such a trust according to its essential nature, namely, as an association. This is true whether the beneficiaries form the trust or, by purchase or otherwise, acquire an interest in an existing trust.

The mere size or amount of capital invested in the trust is of no importance. Sometimes the activity of the trust is a small venture or enterprise, such as the division and sale of a parcel of land, the erection of a building, or the care and rental of an office building or apartment house; sometimes the activity is a trade or business on a much larger scale. The distinction is that between the activity or purpose for which an ordinary strict trust of the traditional type would be created, and the activity or purpose for which a corporation for profit might have been formed.

ART. 901-4. *Partnerships.*—The Act provides its own concept of a partnership. Under the term "partnership" it includes not only a partnership as known at common law but, as well, a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any business, financial operation, or venture, and which is not, within the meaning of the Act, a trust, estate, or a corporation. On the other hand the Act classifies under the term "corporation" an association or joint-stock company, the members of which may be subject to the personal liability of partners. If an organization is not interrupted by the death of a member or by a change in ownership of a participating interest during the agreed period of its existence, and its management is centralized in one or more persons in their representative capacities, such an organization is an association, taxable as a corporation. As to the characteristics of an association, see also articles 901-2 and 901-3. The following examples will illustrate some phases of these distinctions:

(1) If A and B buy some acreage for the purpose of subdivision, they are joint adventurers, and the joint venture is classified by the Act as a partnership.

(2) A, B, and C contribute $10,000 each for the purpose of buying and selling real estate. If A, B, C, or D, an outside party (or any combination of them as long as the approval of each participant is not required for syndicate action), takes control of the money, property and business of the enterprise, and the syndicate is not terminated on the death of any of the participants, the syndicate is classified as an association.

ART. 901-5. *Limited partnership as corporation.*—Limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Michigan, Pennsylvania, and a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, or having other material characteristics of corporate form, must make returns of income and pay the tax as corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized.

ART. 901-6. *Limited partnership as partnership.*—Limited partnerships of the type authorized by the statutes of New York and many other States are ordinarily partnerships and not corporations within the meaning of the Act. Such limited partnerships, which can not limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or attempted transfer of the interest of a general partner, and which can not take real estate or sue in the partnership name, are so like common law partnerships as to render impracticable any differentiation in their treatment for tax purposes.

ART. 901-7. *Insurance company.*—Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. A corporation which merely sets aside a fund for the insurance of its employees is not required to file a separate return for such fund, but the income therefrom shall be included in the return of the corporation.

Though its name, charter powers and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Act. For example, during the year 1938 the M Corporation, incorporated under the insurance laws of the State of R, carried on the business of lending money in addition to guaranteeing the payment of principal and interest of mortgage loans. Of its total income for the year one-third was derived from its insurance business of guaranteeing the payment of principal and interest of mortgage loans and two-thirds was derived from its noninsurance business of lending money. The M Corporation is not an insurance company for the year 1938 within the meaning of the Act and these regulations.

ART. 901–8. *Domestic, foreign, resident, and nonresident persons.*—A domestic corporation is one organized or created in the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, or under the law of the United States or of any State or Territory, and a foreign corporation is one which is not domestic. A domestic corporation is a resident corporation even though it does no business and owns no property in the United States. A foreign corporation engaged in trade or business within the United States or having an office or place of business therein is referred to in these regulations as a resident foreign corporation, and a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein, as a nonresident foreign corporation. A partnership engaged in trade or business within the United States or having an office or place of business therein is referred to in these regulations as a resident partnership, and a partnership not engaged in trade or business within the United States and not having any office or place of business therein, as a nonresident partnership. Whether a partnership is to be regarded as resident, or nonresident is not determined by the nationality or residence of its members or by the place in which it was created or organized. The term "nonresident alien," as used in these regulations, includes a nonresident alien individual and a nonresident alien fiduciary.

ART. 901–9. *Fiduciary.*—"Fiduciary" is a term which applies to persons that occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary for income tax purposes is a person who holds in trust an estate to which another has the beneficial title or in which another has a beneficial interest, or receives and controls income of another, as in the case of receivers. A committee or guardian of the property of an incompetent person is a fiduciary.

ART. 901–10. *Fiduciary distinguished from agent.*—There may be a fiduciary relationship between an agent and a principal, but the word "agent" does not denote a fiduciary. An agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary within the meaning of the Act. In cases where no legal trust has been created in the estate controlled by the agent and attorney, the liability to make a return rests with the principal.

SEC. 902. *Separability clause.*—If any provision of this Act, or the application thereof to any person or circumstances, is held invalid, the remainder of the Act, and the application of such provisions to other persons or circumstances, shall not be affected thereby.

SEC. 903. *Effective date of act.*—Except as otherwise provided, this Act shall take effect upon its enactment.

[Received by the President, May 16, 1938.]

[*Note by the Department of State.*—The foregoing act having been presented to the President of the United States for his approval, and not having been returned by him to the House of Congress in which it originated within the time prescribed by the Constitution of the United States, has become a law without his approval.]

ART. 903–1. *Effective date of Act.*—The date of the enactment of the Act is May 28, 1938.

In pursuance of the Act the foregoing regulations are hereby prescribed and Treasury Decisions 4809, 4810, 4811, 4814, 4865, 4874, and 4875 heretofore issued under Title I are hereby superseded.

[SEAL] GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved, February 7, 1939.

H. MORGENTHAU, Jr.,
Secretary of the Treasury.

APPENDIX

Certain General Provisions of Law and Regulations Applicable to the Tax Imposed on Net Income by Titles I and IA, and on Excess Profits by Title III, of the Revenue Act of 1938, and Certain Provisions of Regulation F of Board of Governors of Federal Reserve System Effective December 1, 1937

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