PART II
Section 1

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TITLE 26—INTERNAL REVENUE

Chapter I—Internal Revenue Service, Department of the Treasury

SUBCHAPTER A—INCOME AND EXCESS PROFITS TAXES

[Regulations 118]

PART 39—INCOME TAX: TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1951

Part II of this issue is divided into two sections. Section 1 contains §§ 39.1 through 39.118-1 of Part 39, Chapter I, Title 26, and Section 2 contains §§ 39.119 (a) through 39.6000-1.

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39.101 (5) Statutory provisions; exemptions from tax on corporations; cemetery companies.
39.101 (5)-1 Cemetery companies.
39.101 (6) Statutory provisions; exemptions from tax on corporations; religious, charitable, etc., organizations.
39.101 (6)-1 Religious, charitable, scientific, literary, and educational organizations and community chests.
39.101 (7) Statutory provisions; exemptions from tax on corporations; business leagues, etc.
39.101 (7)-1 Business leagues, chambers of commerce, real estate boards, and boards of trade.
39.101 (8) Statutory provisions; exemptions from tax on corporations; civic organizations.
39.101 (8)-1 Civic leagues and local associations of employees.
39.101 (9) Statutory provisions; exemptions from tax on corporations; social clubs.
39.101 (9)-1 Social clubs.
39.101 (10) Statutory provisions; exemptions from tax on corporations; benevolent life insurance associations and mutual or cooperative companies.
39.101 (10)-1 Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.
39.101 (11) Statutory provisions; exemptions from tax on corporations; mutual insurance organizations other than life or marine.
39.101 (11)-1 Mutual insurance companies or associations.
39.101 (12) Statutory provisions; exemptions from tax on corporations; cooperative farmers', fruit growers, etc., associations.
39.101 (12)-1 Farmers' cooperative marketing and purchasing associations; requirements for exemption under section 101 (12) (A).
39.101 (12)-2 Tax treatment of farmers' cooperative marketing and purchasing associations exempt under section 101 (12) (A).

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39.101 (12)-3 Manner of taxation of cooperative associations subject to section 101 (12).
39.101 (12)-4 Patronage dividends, rebates, or refunds; treatment as to cooperative associations entitled to tax treatment under section 101 (12) (B).
39.101 (13) Statutory provisions; exemptions from tax on corporations; corporations organized to finance crop operations.
39.101 (13)-1 Corporations organized to finance crop operations.
39.101 (14) Statutory provisions; exemptions from tax on corporations; corporations organized to hold title to property for exempt organizations.
39.101 (14)-1 Corporations organized to hold title to property for exempt organizations.
39.101 (15)-(18) Statutory provisions; exemptions from tax on corporations; instrumentalities of the United States; employees' beneficiary associations; teachers' retirement fund associations; religious or apostolic organizations.
39.101 (18)-1 Religious or apostolic associations or corporations.
39.101 (19) Statutory provisions; exemptions from tax on corporations; employees' beneficiary associations.
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39.102-1 Taxation of corporation formed or utilized for avoidance of surtax.
39.102-2 Purpose to avoid surtax; evidence; burden of proof; definition of holding or investment company.
39.102-3 Unreasonable accumulation of profits.
39.102-4 Computation of undistributed section 102 net income.
39.103-104 Statutory provisions; tax on citizens and corporations of certain foreign countries; banks and trust companies.
39.104-1 Tax on banks.
39.104-2 Mutual savings banks, building and loan associations, and cooperative banks.
39.105 Statutory provisions; sale of oil or gas properties.
39.105-1 Surtax on sale of oil or gas properties.
39.106 Statutory provisions; claims against United States involving acquisition of property.
39.106-1 Surtax on certain amounts received from the United States.
39.107 Statutory provisions; compensation for services rendered for a period of 36 months or more and back pay.
39.107-1 Personal services.
39.107-2 Artistic work or invention.
39.107-3 Back pay attributable to prior taxable years.
39.108 Statutory provisions; fiscal year taxpayers.
39.108-1 Computation of tax of individuals for taxable years beginning in 1953 and ending in 1954.
39.108-2 Computation of tax of corporations for taxable years beginning before April 1, 1954, and ending after March 31, 1954.
39.109 Statutory provisions; Western Hemisphere trade corporations.
39.109-1 Western Hemisphere trade corporations.
39.110 Statutory provisions; mutual savings banks conducting life insurance business.
39.110-1 Mutual savings banks conducting life insurance business.

SUPPLEMENT B—COMPUTATION OF NET INCOME

39.111 Statutory provisions; determination of amount of, and recognition of, gain or loss.
39.111-1 Computation of gain or loss.
39.112 (a) Statutory provisions; recognition of gain or loss; general rule.
39.112 (a)-1 Sales or exchanges.

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39.112 (a)-2 Use of term "assumption of liabilities."
39.112 (b) (1) Statutory provisions; recognition of gain or loss; exchanges solely in kind; property held for productive use or investment.
39.112 (b) (1)-1 Property held for productive use in trade or business or for investment.
39.112 (b) (2) Statutory provisions; recognition of gain or loss; exchanges solely in kind; stock for stock of same corporation.
39.112 (b) (2)-1 Stock for stock of the same corporation.
39.112 (b) (3)-(5) Statutory provisions; recognition of gain or loss; exchanges solely in kind; stock for stock on reorganization; gain of corporation; transfer to corporation controlled by transferor.
39.112 (b) (5)-1 Transfer of property to corporation controlled by transferor.
39.112 (b) (5)-2 Treatment of assumptions of liabilities.
39.112 (b) (5)-3 Records to be kept and information to be filed.
39.112 (b) (6) Statutory provisions; recognition of gain or loss; exchanges solely in kind; property received by corporation on complete liquidation of another.
39.112 (b) (6)-1 Distributions in liquidation of subsidiary corporation.
39.112 (b) (6)-2 Liquidations completed within one taxable year.
39.112 (b) (6)-3 Liquidations covering more than one taxable year.
39.112 (b) (6)-4 Distributions in liquidation as affecting minority interests.
39.112 (b) (6)-5 Records to be kept and information to be filed with return.
39.112 (b) (7) Statutory provisions; recognition of gain or loss; exchanges solely in kind; election as to recognition of gain in certain corporate liquidations.
39.112 (b) (7)-1 Corporate liquidation in calendar month in 1952.
39.112 (b) (7)-2 Qualified electing shareholder.
39.112 (b) (7)-3 Making and filing of written elections.
39.112 (b) (7)-4 Treatment of gain.
39.112 (b) (7)-5 Records to be kept and information to be filed with return.
39.112 (b) (8)-(9) Statutory provisions; recognition of gain or loss; exchanges solely in kind; exchanges and distributions in obedience to orders of Securities and Exchange Commission; property transfers on certain railroad reorganizations.
39.112 (b) (9)-1 Nonrecognition of loss upon transfer of property of railroad corporation.
39.112 (b) (10) Statutory provisions; recognition of gain or loss; exchanges solely in kind; transfers of property on reorganization of corporations in certain receivership and bankruptcy proceedings.
39.112 (b) (10)-1 Transfer of property of insolvent corporation in corporate reorganization receivership proceeding.
39.112 (b) (10)-2 Records to be kept and information to be filed.
39.112 (b) (11) Statutory provisions; recognition of gain or loss; exchanges solely in kind; distribution of stock not in liquidation.
39.112 (b) (11)-1 Certain distributions of stock on reorganization.
39.112 (b) (11)-2 Limitations upon the application of section 112 (b) (11).
39.112 (c) Statutory provisions; recognition of gain or loss; gain from exchanges not solely in kind.
39.112 (c)-1 Receipt of other property or money in tax-free exchange not connected with corporate reorganization.

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39.112 (d)-(e) Statutory provisions; recognition of gain or loss; gain of corporation from exchanges not solely in kind; loss from exchanges not solely in kind.
39.112 (e)-1 Nonrecognition of loss.
39.112 (f) Statutory provisions; recognition of gain or loss; involuntary conversion of property.
39.112 (f)-1 Involuntary conversion where disposition of the converted property occurred after December 31, 1950.
39.112 (g) Statutory provisions; recognition of gain or loss; definition of reorganization.
39.112 (g)-1 Purpose and scope of exception of reorganization exchanges.
39.112 (g)-2 Definition of terms.
39.112 (g)-3 Exchanges solely of stock or securities, or property, solely for stock or securities, in pursuance of plan of reorganization.
39.112 (g)-4 Exchanges in reorganization for stock or securities and other property or money.
39.112 (g)-5 Receipt of stock or securities in reorganization without surrender of stock by shareholder.
39.112 (g)-6 Records to be kept and information to be filed with returns.
39.112 (h) Statutory provisions; recognition of gain or loss; definition of control.
39.112 (h)-1 Control of corporation.
39.112 (i) Statutory provisions; recognition of gain or loss; exchanges involving foreign corporations.
39.112 (i)-1 Reorganization with, or transfer of property to or from, a foreign corporation.
39.112 (j)-(k) Statutory provisions; recognition of gain or loss; cross reference; assumption of liability.
39.112 (k)-1 Assumption of liabilities not to be taken into account for purpose of recognizing gain or loss.
39.112 (l) Statutory provisions; recognition of gain or loss; exchanges by security holders in connection with certain corporate reorganizations.
39.112 (l)-1 Exchange in connection with reorganization of insolvent corporation.
39.112 (l)-2 Records to be kept and information to be filed.
39.112 (m) Statutory provisions; recognition of gain or loss; gain from sale or exchange to effectuate policies of Federal Communications Commission.
39.112 (m)-1 Gain from sale or exchange to effectuate policies of Federal Communications Commission.
39.112 (m)-2 Nature and effect of election.
39.112 (m)-3 Reduction of basis of property pursuant to election under section 112 (m).
39.112 (m)-4 Manner of election.
39.112 (n) Statutory provisions; recognition of gain or loss; gain from sale or exchange of residence.
39.112(n)-1 Gain from sale or exchange of residence.
39.113 (a) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; general rule.
39.113 (a)-1 Scope of basis for determining gain or loss.
39.113 (a)-2 General rule.
39.113 (a) (1) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; inventory items.
39.113 (a) (1)-1 Property included in inventory.
39.113 (a) (2) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; gifts after December 31, 1920.
39.113 (a) (2)-1 Property transmitted by gift after December 31, 1920.
39.113 (a) (3) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; transfers in trust after December 31, 1920.

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39.113 (a) (3)-1 Transfer in trust after December 31, 1920.
39.113 (a) (4) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; gifts or transfers in trust before January 1, 1921.
39.113 (a) (4)-1 Gift or transfer in trust before January 1, 1921.
39.113 (a) (5) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property transmitted at death.
39.113 (a) (5)-1 Basis of property acquired by bequest, devise, or inheritance.
39.113 (a) (6) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; tax-free exchanges generally.
39.113 (a) (6)-1 Property acquired upon a tax-free exchange.
39.113 (a) (6)-2 Treatment of assumption of liabilities.
39.113 (a) (7) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; transfers to corporation.
39.113 (a) (7)-1 Property acquired by corporation in reorganization after December 31, 1917.
39.113 (a) (8) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired by issuance of stock or as paid-in surplus.
39.113 (a) (8)-1 Property acquired by a corporation after December 31, 1920.
39.113 (a) (9) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; involuntary conversions.
39.113 (a) (9)-1 Property acquired as a result of an involuntary conversion.
39.113 (a) (10) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; wash sales of stock.
39.113 (a) (10)-1 Stocks or securities acquired in "wash sales."
39.113 (a) (11) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired during affiliation.
39.113 (a) (11)-1 Basis of property acquired during affiliation.
39.113 (a) (12) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; basis established by Revenue Act of 1932.
39.113 (a) (12)-1 Basis of property established by Revenue Act of 1932.
39.113 (a) (13) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired by or from partnerships.
39.113 (a) (13)-1 Property contributed in kind by a partner to a partnership.
39.113 (a) (13)-2 Readjustment of partnership interests.
39.113 (a) (14) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired before March 1, 1913.
39.113 (a) (14)-1 Property acquired before March 1, 1913.
39.113 (a) (15) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property received by a corporation on complete liquidation of another.
39.113 (a) (15)-1 Basis of property received by a corporation in complete liquidation of another corporation.
39.113 (a) (16) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; basis established by Revenue Act of 1934.
39.113 (a) (16)-1 Basis of property established by Revenue Act of 1934.

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39.113 (a) (17)-(18) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; cross reference; property received in certain corporate liquidations.
39.113 (a) (18)-1 Basis of property received in certain corporate liquidations.
39.113 (a) (19) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; stock dividends and stock rights.
39.113 (a) (19)-1 Basis of stock and rights involved in the acquisition of stock dividends or stock rights; general rules.
39.113 (a) (19)-2 Exceptions to general rules.
39.113 (a) (20) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired by railroad corporation.
39.113 (a) (20)-1 Property acquired by railroad corporation in a receivership or railroad reorganization proceeding.
39.113 (a) (21) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired by street, suburban, or interurban electric railway corporation.
39.113 (a) (21)-1 Property acquired by electric railway corporation in corporate reorganization proceeding.
39.113 (a) (22) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired on reorganization of certain corporations.
39.113 (a) (22)-1 Basis of property acquired by corporation as result of certain corporate reorganization or receivership proceedings.
39.113 (a) (23) Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; stock acquired in tax-free distributions.
39.113 (a) (23)-1 Basis of stock on certain distributions on reorganization.
39.113 (b) (1) Statutory provisions; adjusted basis for determining gain or loss; general rule.
39.113 (b) (1)-1 Adjusted basis.
39.113 (b) (1)-2 Adjusted basis; cancellation of indebtedness.
39.113 (b) (1)-3 Adjusted basis; cancellation of indebtedness; special cases.
39.113 (b) (1)-4 Adjusted basis; mutual savings banks, building and loan associations, and cooperative banks.
39.113 (b) (2) Statutory provisions; adjusted basis for determining gain or loss; substituted basis.
39.113 (b) (2)-1 Substituted basis.
39.113 (b) (3) Statutory provisions; adjusted basis for determining gain or loss; discharge of indebtedness.
39.113 (b) (3)-1 Adjusted basis; discharge of corporate indebtedness; general rule.
39.113 (b) (3)-2 Adjusted basis; discharge of corporate indebtedness; special cases.
39.113 (b) (4) Statutory provisions; adjusted basis for determining gain or loss; adjustment of capital structure before September 22, 1938.
39.113 (b) (4)-1 Adjusted basis; exception to section 270 of the Bankruptcy Act, as amended.
39.113 (c) Statutory provisions; adjusted basis for determining gain or loss; property on which lessee has made improvements.
39.113 (c)-1 Property on which lessee has made improvements.
39.113 (d) Statutory provisions; adjusted basis for determining gain or loss; depreciation, etc., allowed before 1952.
39.113 (d)-1 Election as to amounts allowed in respect of depreciation, etc., before 1952.
39.114 Statutory provisions; basis for depreciation and depletion.
39.114-1 Basis for allowance of depreciation and depletion.
39.115 (a) Statutory provisions; distributions by corporations; definition of dividend.
39.115 (a)-1 Dividends.
39.115 (a)-2 Earnings or profits.
39.115 (a)-3 Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.
39.115 (b) Statutory provisions; distributions by corporations; source of distribution.
39.115 (b)-1 Sources of distribution in general.
39.115 (c) Statutory provisions; distributions by corporations; distributions in liquidation.
39.115 (c)-1 Distributions in liquidation.
39.115 (d) Statutory provisions; distributions by corporations; other distributions from capital.
39.115 (d)-1 Distributions other than a dividend.
39.115 (d)-2 Distributions from depletion or depreciation reserves.
39.115 (e)-(f) Statutory provisions; distributions by corporations; distributions by personal service corporations; stock dividends.
39.115 (f)-1 Stock dividends.
39.115 (f)-2 Election of shareholders as to medium of payment.
39.115 (g) Statutory provisions; distributions by corporations; redemption of stock.
39.115 (g)-1 Distribution in redemption or cancellation of stock taxable as a dividend.
39.115 (h)-(j) Statutory provisions; distributions by corporations; effect on earnings and profits of distributions of stock; definition of partial liquidation; valuation of dividend.
39.115 (j)-1 Dividends paid in property.
39.115 (k)-(l) Statutory provisions; distributions by corporations; cross reference; effect on earnings and profits of gain or loss and of receipt of tax-free distributions.
39.115 (l)-1 Effect on earnings and profits of gain or loss realized after February 28, 1913.
39.115 (l)-2 Effect on earnings and profits of receipt of tax-free distributions requiring adjustment or allocation of basis of stock.
39.115 (m) Statutory provisions; distributions by corporations; earnings and profits, increase in value of property accrued before March 1, 1913.
39.115 (m)-1 Adjustments to earnings and profits reflecting increase in value accrued before March 1, 1913.
39.116 Statutory provisions; additional exclusions from gross income.
39.116-1 Earned income from sources without the United States.
39.116-2 Income of foreign governments, international organizations, and their employees.
39.116-3 Bridges to be acquired by State or political subdivisions.
39.116-4 Exclusion of certain cost-of-living allowances.
39.116-5 Exclusion of certain allowances of Foreign Service personnel.
39.116-6 Exclusion of certain income from sources within Puerto Rico.
39.117 (a) Statutory provisions; capital gains and losses; definitions.
39.117 (a)-1 Meaning of terms.
39.117 (b) Statutory provisions; capital gains and losses; deduction from gross income.
39.117 (b)-1 Deduction for long-term capital gains.
39.117 (c) Statutory provisions; capital gains and losses; alternative taxes.
39.117 (c)-1 Alternative tax in case net long-term capital gain exceeds net short-term capital loss.
39.117 (d) Statutory provisions; capital gains and losses; limitation on capital losses.
39.117 (d)-1 Limitation on capital losses.
39.117 (e) Statutory provisions; capital gains and losses; capital loss carry-over.
39.117 (e)-1 Net capital loss carry-over.
39.117 (f)-(g) Statutory provisions; capital gains and losses; retirement of bonds, etc., gains and losses from short sales, etc.
39.117 (g)-1 Gains and losses from short sales; in general.
39.117 (g)-2 Gain attributable to amortization deduction.
39.117 (h) Statutory provisions; capital gains and losses; holding period of property.
39.117 (h)-1 Determination of period for which capital assets are held.
39.117 (i)-(j) Statutory provisions; capital gains and losses; bond, etc., losses of banks; gains and losses from involuntary conversions and from sales or exchanges of certain property used in the trade or business.
39.117 (j)-1 Gains and losses from involuntary conversions and from the sale or exchange of certain property used in the trade or business.
39.117 (j)-2 Livestock held for draft, breeding, or dairy purposes.
39.117 (k) Statutory provisions; capital gains and losses; gain or loss in the case of timber or coal.
39.117 (k)-1 Gain or loss upon the cutting and disposal of timber and the disposal of coal.
39.117 (l) Statutory provisions; capital gains and losses; short sales, etc.
39.117 (l)-1 Gains and losses from certain short sales of capital assets.
39.117 (m) Statutory provisions; capital gains and losses; collapsible corporations.
39.117 (m)-1 Collapsible corporations.
39.117 (n) Statutory provisions; gains and losses from sales or exchanges of securities by dealers in securities.
39.117 (n)-1 Dealers in securities.
39.117 (o) Statutory provisions; gain from sale of certain property between spouses or between an individual and a controlled corporation.
39.117 (o)-1 Gain from sale or exchange of certain property between spouses or between an individual and a controlled corporation.
39.117 (p) Statutory provisions; treatment of termination payments to employee.
39.117 (p)-1 Capital gains treatment of certain termination payments.
39.118 Statutory provisions; losses from wash sales of stock or securities.
39.118-1 Losses from wash sales of stock or securities.
39.119 (a) Statutory provisions; income from sources within the United States; gross income.
39.119 (a)-1 Interest.
39.119 (a)-2 Dividends.
39.119 (a)-3 Compensation for labor or personal services.
39.119 (a)-4 Rentals and royalties.
39.119 (a)-5 Sale of real property.
39.119 (a)-6 Sale of personal property.
39.119 (a)-7 Other income from sources within the United States.
39.119 (b) Statutory provisions; income from sources within the United States; net income.
39.119 (b)-1 Apportionment of deductions.
39.119 (c) Statutory provisions; income from sources within the United States; gross income from sources without the United States.
39.119 (c)-1 Income from sources without the United States.

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39.119 (d)-(e) Statutory provisions; income from sources within the United States; net income from sources without the United States; income from sources partly within and partly without the United States.
39.119 (e)-1 Income from the sale of personal property derived from sources partly within and partly without the United States.
39.119 (e)-2 Transportation service.
39.119 (e)-3 Telegraph and cable service.
39.119 (e)-4 Computation of income.
39.119 (f) Statutory provisions; income from sources within the United States; definitions.
39.120 Statutory provisions; unlimited deduction for charitable and other contributions.
39.120-1 Unlimited deduction for charitable and other contributions.
39.121-122 Statutory provisions; deductions of dividends paid on certain preferred stock of certain corporations; net operating loss deduction.
39.122-1 Net operating loss deduction.
39.122-2 Computation of net operating loss in case of corporation.
39.122-3 Computation of net operating loss in case of a taxpayer other than a corporation.
39.122-4 Computation of net operating loss carry-overs and net operating loss carry-back.
39.122-5 Conversion of net operating loss carry-back and net operating loss carry-overs into net operating loss deduction.
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39.123-1 Election to include loans in income.
39.123-2 Effect of election on adjustments for other taxable years.
39.124 Statutory provisions; amortization deduction.
39.124A (a) Statutory provisions; amortization deduction; general rule.
39.124A (a)-1 Amortization deduction; general rule.
39.124A (b) Statutory provisions; amortization deduction; election.
39.124A (b)-1 Election of amortization.
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39.124A (c)-1 Election to discontinue amortization.
39.124A (d) Statutory provisions; amortization deduction; definitions.
39.124A (d)-1 Definitions.
39.124A (e) Statutory provisions; amortization deduction; adjusted basis of emergency facility.
39.124A (e)-1 Adjusted basis of emergency facility.
39.124A (f) Statutory provisions; amortization deduction; depreciation.
39.124A (f)-1 Depreciation of portion of emergency facility not subject to amortization.
39.124A (g) Statutory provisions; amortization deduction; payment by United States of unamortized cost of facility.
39.124A (g)-1 Payment by United States of unamortized cost of facility.
39.124A (h) Statutory provisions; amortization deduction; life tenant and remainderman.
39.124A (h)-1 Life tenant and remainderman.
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39.124A (i)-1 Cross reference.
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39.125 (a)-1 In general.
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39.125 (b)-1 Bond premium and amortizable bond premium.
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39.125 (b)-4 Taxable years in which interest not received or accruable.
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39.125 (c)-2 Partially tax-exempt bonds owned by estates, trusts, partnerships, etc.
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39.126 (a)-1 Inclusion in gross income of income in respect of a decedent.
39.126 (b) Statutory provisions; income in respect of decedents; allowance of deductions and credit.
39.126 (b)-1 Allowance of deductions and credit in respect of decedent.
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39.126 (c)-1 Deduction for estate tax attributable to income in respect of decedent.
39.127 (a) Statutory provisions; war losses; application.
39.127 (a)-1 War losses generally.
39.127 (b)-(c) Statutory provisions; war losses; amount of loss; recoveries.
39.127 (c)-1 Recoveries in respect of war losses.
39.127 (d) Statutory provisions; war losses; basis of recovered property.
39.127 (d)-1 Basis of recovered property.
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39.127 (f)-1 Determination of tax benefits from allowable deductions.
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39.128-1 Recovery of unconstitutional taxes.
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39.129-2 Purpose and scope of section 129.
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39.130-1 Limitation on deductions allowable to individuals in certain cases.
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39.130A-1 Meaning and use of certain terms.
39.130A-2 Restricted stock option.
39.130A-3 Exercise of restricted stock option.
39.130A-4 Modification, extension, or renewal.
39.130A-5 Operation of section 130A.

SUPPLEMENT C—CREDITS AGAINST TAX

39.131 (a) Statutory provisions; taxes of foreign countries and possessions of United States; allowance of credit.
39.131 (a)-1 Analysis of credit for taxes.
39.131 (a)-2 Countries which do or do not satisfy the similar credit requirement.
39.131 (b) Statutory provisions; taxes of foreign countries and possessions of United States; limit on credit.
39.131 (b)-1 Limitations on credit for foreign taxes.
39.131 (c) Statutory provisions; taxes of foreign countries and possessions of United States; adjustments on payment of accrued taxes.
39.131 (c)-1 Redetermination of tax when credit proves incorrect.
39.131 (c)-2 Credit for taxes accrued but not paid.
39.131 (d) Statutory provisions; taxes of foreign countries and possessions of United States; year in which credit taken.
39.131 (d)-1 When credit for taxes may be taken.
39.131 (e) Statutory provisions; taxes of foreign countries and possessions of United States; proof of credits.
39.131 (e)-1 Conditions of allowance of credit.
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39.131 (f)-1 Taxes of foreign corporation.
39.131 (g)-(h) Statutory provisions; taxes of foreign countries and possessions of United States; corporations treated as foreign; credit for taxes in lieu of income, etc., taxes.
39.131 (h)-1 Meaning of terms.
39.131 (i)-(j) Statutory provisions; taxes of foreign countries and possessions of United States; tax withheld at source; tax imposed by subchapter D.
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39.141 Statutory provisions; consolidated returns.
39.141-1 Consolidated income and excess profits tax returns of affiliated corporations.
39.142 Statutory provisions; fiduciary returns.
39.142-1 Fiduciary returns.
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39.142-6 Time for filing return upon death, or termination of trust.
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SUBPART G—MISCELLANEOUS PROVISIONS

39.6000-1 Extension of time for making certain elections.

AUTHORITY: §§ 39.1 to 39.6000-1 issued under 53 Stat. 32, 457; 26 U. S. C. 62, 3791.

SUBPART A—INTRODUCTORY PROVISIONS (CHAPTER I, INTERNAL REVENUE CODE)

§ 39.1 *Statutory provisions; application of Chapter 1.*

SEC. 1. *Application of chapter.* The provisions of this chapter shall apply only to taxable years beginning after December 31, 1938. Income, war-profits, and excess-profits taxes for taxable years beginning prior to January 1, 1939, shall not be affected by the provisions of this chapter, but shall remain subject to the applicable provisions of the Revenue Act of 1938 and prior revenue acts, except as such provisions are modified by legislation enacted subsequent to the Revenue Act of 1938.

§ 39.1-1 *Scope and applicability of regulations.* (a) The regulations in this part deal with (1) the taxes imposed by chapter 1 of the Internal Revenue Code, except the excess profits tax imposed under subchapter D, (2) the surtax imposed by subchapter A of chapter 2 (sections 500 to 511, inclusive) upon the undistributed subchapter A net income of personal holding companies, and (3) administrative provisions relating to such taxes.

(b) The regulations in this part are applicable only with respect to taxable years beginning after December 31, 1951.

§ 39.2-3 *Statutory provisions; cross references in Chapter 1, classification of provisions in Chapter 1.*

SEC. 2. *Cross references.* The cross references in this chapter to other portions of the chapter, 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 chapter are herein classified and designated as—

Subchapter A—Introductory provisions,
Subchapter B—General provisions, divided into Parts and sections,
Subchapter C—Supplemental provisions, divided into Supplements and sections.
Subchapter E—Tax on Self-Employment Income (the Self-Employment Contributions Act), divided into sections.

[Sec. 3 as amended by sec. 172 (b), Rev. Act 1942; sec. 6 (b), Individual Income Tax Act 1944; sec. 208 (d), Social Security Act Amendments 1950]

§ 39.3-1 *Division of regulations.* These regulations, which constitute Part 39 of Title 26 of the Code of Federal Regulations, are divided into seven subparts. Subpart A relates to Introductory Provisions of Chapter 1 of the Internal Revenue Code. Subpart B relates to General Provisions of Chapter 1 of the Internal Revenue Code. Subpart C relates to Supplemental Provisions of Chapter 1 of the Internal Revenue Code. Subpart D relates to Tax on Self-Employment Income. Subpart E relates to Surtax on Personal Holding Companies. Subpart F relates to Administrative and General Provisions. Subpart G relates to Miscellaneous Provisions.

§ 39.4 *Statutory provisions; classes of taxpayers.*

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) Regulated investment companies—Supplement Q.
(k) Shareholders of personal service corporations—Supplement S.
(l) Individuals with adjusted gross income of less than $5,000—Supplement T.

[Sec. 4 as amended by sec. 102 (c), Rev. Act 1941; sec. 170 (b), Rev. Act 1942; sec. 5 (b), Individual Income Tax Act 1944]

§ 39.4-1 *Application of regulations to special classes of taxpayers.* With respect to certain classes of taxpayers, the application of the provisions of Subpart B of this part is subject to certain exceptions and additional provisions, which appear in Subpart C of this part, in connection with the following sections of the Internal Revenue Code:

Estates and trusts—sections 161 to 172, inclusive.
Partnerships—sections 181 to 191, inclusive.
Insurance companies—sections 201 to 207, inclusive.
Nonresident alien individuals—sections 211 to 221, inclusive.
Foreign corporations—sections 231 to 238, inclusive.
Income from sources in possessions of the United States—sections 251 and 252.
China Trade Act corporations—sections 261 to 265, inclusive.
Foreign personal holding companies—sections 331 to 340, inclusive.
Regulated investment companies—sections 361 and 362.
Shareholders of personal service corporations—sections 391 to 396, inclusive.
Individuals entitled to elect to pay the tax under Supplement T—sections 400 to 404, inclusive.
Tax-exempt organizations with taxable business income under Supplement U—sections 421 to 424, inclusive.

SUBPART B—GENERAL PROVISIONS (CHAPTER I, INTERNAL REVENUE CODE)

RATES OF TAX

§ 39.11 *Statutory provisions; normal tax on individuals.*

SEC. 11. *Normal tax on individuals*—(a) *Taxable years beginning after September 30, 1950.* In case of taxable years beginning after September 30, 1950, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 3 per centum of the amount of the net income in excess of the credits against net income provided in section 25. For alternative tax which may be elected if adjusted gross income is less than $5,000, see supplement T.

(b) *Taxable years beginning before October 1, 1950.* * * * [Not applicable.]

[Sec. 11 as amended by sec. 102 (b) (1), Rev. Act 1941; sec. 102, Rev. Act 1942; sec. 3, Individual Income Tax Act 1944; sec. 101 (a), Rev. Act 1945; sec. 104 (a), Rev. Act 1948; sec. 101 (a), Rev. Act 1950]

§ 39.11-1 *Income tax on individuals.* Chapter 1 of the Internal Revenue Code imposes an income tax on individuals consisting of a normal tax (section 11) and a surtax (section 12) For optional tax in the case of taxpayers with adjusted gross incomes of less than $5,000, see section 400 and § 39.400-1. The normal tax on individuals is at the rate of 3 percent and is upon net income (deter-

mined by subtracting the allowable deductions from the gross income) reduced by the amount of the credits against net income provided in section 25. In certain cases credits are allowed against the amount of the tax (sections 31, 32, 35, and 131). For computation of tax in the case of a joint return of husband and wife, see § 39.12-4. For treatment of taxable years beginning in 1953 and ending in 1954, see § 39.108-1. In general, the tax is payable upon the basis of returns rendered by persons liable therefor (sections 51, 53, 142, and 217) or at the source of the income. Exceptions and additional provisions applicable to certain special classes of taxpayers are listed in § 39.4-1. See Supplement P (sections 331 to 340, inclusive) as to shareholders of foreign personal holding companies. See section 117 as to the treatment of capital gains and capital losses.

§ 39.11-2 *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. A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year is, in general, liable to the tax in the same manner as a resident alien individual. See sections 116 (l) and 220. As to nonresident alien individuals, see sections 211 to 221, inclusive.

§ 39.11-3 *Who is a citizen.* Every person born or naturalized in the United States, and subject to its jurisdiction, is a citizen. For rules governing the expatriation of citizens by birth and naturalized citizens, see sections 349 to 357, inclusive, of the Immigration and Nationality Act, 1952 (8 U. S. C. 1481-1489). A foreigner who has filed his declaration of intention of becoming a citizen but who has not yet been admitted to citizenship by a final order of a naturalization court is an alien. See §§ 39.211-2 to 39.211-5, inclusive, for distinction between a resident alien individual and a nonresident alien individual.

§ 39.12 *Statutory provisions; surtax on individuals.*

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 (a).

(b) *Rates of surtax.* (1) *Calendar year 1951.* * * * [not applicable.]

(2) *Taxable years beginning after October 31, 1951, and before January 1, 1954.* In the case of taxable years beginning after October 31, 1951, and before January 1, 1954, there shall be levied, collected, and paid for each taxable year upon the surtax net income of every individual (other than a head of a household to whom subsection (c) applies) the surtax shown in the following table:

If the surtax net income is—	*The surtax shall be—*
Not over $2,000	19.2 percent of the surtax net income.
Over $2,000 but not over $4,000	$384, plus 21.6 percent of excess over $2,000.
Over $4,000 but not over $6,000	$816, plus 26 percent of excess over $4,000.
Over $6,000 but not over $8,000	$1,336, plus 31 percent of excess over $6,000.
Over $8,000 but not over $10,000	$1,956, plus 35 percent of excess over $8,000.
Over $10,000 but not over $12,000	$2,656, plus 39 percent of excess over $10,000.
Over $12,000 but not over $14,000	$3,436, plus 45 percent of excess over $12,000.
Over $14,000 but not over $16,000	$4,336, plus 50 percent of excess over $14,000.
Over $16,000 but not over $18,000	$5,336, plus 53 percent of excess over $16,000.
Over $18,000 but not over $20,000	$6,396, plus 56 percent of excess over $18,000.
Over $20,000 but not over $22,000	$7,516, plus 59 percent of excess over $20,000.
Over $22,000 but not over $26,000	$8,696, plus 63 percent of excess over $22,000.
Over $26,000 but not over $32,000	$11,216, plus 64 percent of excess over $26,000.
Over $32,000 but not over $38,000	$15,056, plus 65 percent of excess over $32,000.
Over $38,000 but not over $44,000	$18,956, plus 69 percent of excess over $38,000.
Over $44,000 but not over $50,000	$23,096, plus 72 percent of excess over $44,000.
Over $50,000 but not over $60,000	$27,416, plus 74 percent of excess over $50,000.
Over $60,000 but not over $70,000	$34,816, plus 77 percent of excess over $60,000.
Over $70,000 but not over $80,000	$42,516, plus 80 percent of excess over $70,000.
Over $80,000 but not over $90,000	$50,516, plus 82 percent of excess over $80,000.
Over $90,000 but not over $100,000	$58,716, plus 85 percent of excess over $90,000.
Over $100,000 but not over $150,000	$67,216, plus 87 percent of excess over $100,000.
Over $150,000 but not over $200,000	$110,716, plus 88 percent of excess over $150,000.
Over $200,000	$154,716, plus 89 percent of excess over $200,000.

(3) *Taxable years beginning after December 31, 1953.* In the case of taxable years beginning after December 31, 1953, there shall be levied, collected, and paid for each taxable year upon the surtax net income of every individual (other than a head of a household to whom subsection (c) applies) the surtax shown in the following table:

If the surtax net income is—	*The surtax shall be—*
Not over $2,000	17 percent of the surtax net income.
Over $2,000 but not over $4,000	$340, plus 19 percent of excess over $2,000.
Over $4,000 but not over $6,000	$720, plus 23 percent of excess over $4,000.
Over $6,000 but not over $8,000	$1,180, plus 27 percent of excess over $6,000
Over $8,000 but not over $10,000	$1,720, plus 31 percent of excess over $8,000.
Over $10,000 but not over $12,000	$2,340, plus 35 percent of excess over $10,000.
Over $12,000 but not over $14,000	$3,040, plus 40 percent of excess over $12,000.
Over $14,000 but not over $16,000	$3,840, plus 44 percent of excess over $14,000.
Over $16,000 but not over $18,000	$4,720, plus 47 percent of excess over $16,000.
Over $18,000 but not over $20,000	$5,660, plus 50 percent of excess over $18,000.
Over $20,000 but not over $22,000	$6,660, plus 53 percent of excess over $20,000.
Over $22,000 but not over $26,000	$7,720, plus 56 percent of excess over $22,000.
Over $26,000 but not over $32,000	$9,960, plus 59 percent of excess over $26,000.
Over $32,000 but not over $38,000	$13,500, plus 62 percent of excess over $32,000.
Over $38,000 but not over $44,000	$17,220, plus 66 percent of excess over $38,000.
Over $44,000 but not over $50,000	$21,180, plus 69 percent of excess over $44,000.
Over $50,000 but not over $60,000	$25,320, plus 72 percent of excess over $50,000.
Over $60,000 but not over $70,000	$32,520, plus 75 percent of excess over $60,000.
Over $70,000 but not over $80,000	$40,020, plus 78 percent of excess over $70,000.
Over $80,000 but not over $90,000	$47,820, plus 81 percent of excess over $80,000.
Over $90,000 but not over $100,000	$55,920, plus 84 percent of excess over $90,000.
Over $100,000 but not over $150,000	$64,320, plus 86 percent of excess over $100,000.
Over $150,000 but not over $200,000	$107,320, plus 87 percent of excess over $150,000.
Over $200,000	$150,820, plus 88 percent of excess over $200,000.

(c) *Rates of surtax; head of household*—(1) *Taxable years beginning after October 31, 1951, and before January 1, 1954.* In the case of taxable years beginning after October 31, 1951, and before January 1, 1954, there shall be levied, collected, and paid for each taxable year upon the surtax net income of every individual who is the head of a household the surtax shown in the following table:

If the surtax net income is—	*The surtax shall be—*
Not over $2,000	19.2 percent of the surtax net income.
Over $2,000 but not over $4,000	$384, plus 20.4 percent of excess over $2,000.
Over $4,000 but not over $6,000	$792, plus 24 percent of excess over $4,000.
Over $6,000 but not over $8,000	$1,272, plus 26 percent of excess over $6,000.
Over $8,000 but not over $10,000	$1,792, plus 31 percent of excess over $8,000.
Over $10,000 but not over $12,000	$2,412, plus 32 percent of excess over $10,000.
Over $12,000 but not over $14,000	$3,052, plus 38 percent of excess over $12,000.
Over $14,000 but not over $16,000	$3,812, plus 41 percent of excess over $14,000.
Over $16,000 but not over $18,000	$4,632, plus 44 percent of excess over $16,000.
Over $18,000 but not over $20,000	$5,512, plus 45 percent of excess over $18,000.
Over $20,000 but not over $22,000	$6,412, plus 49 percent of excess over $20,000.
Over $22,000 but not over $24,000	$7,392, plus 51 percent of excess over $22,000.
Over $24,000 but not over $28,000	$8,412 ,plus 54 percent of excess over $24,000.
Over $28,000 but not over $32,000	$10,572, plus 57 percent of excess over $28,000.
Over $32,000 but not over $38,000	$12,852, plus 60 percent of excess over $32,000.
Over $38,000 but not over $44,000	$16,452, plus 63 percent of excess over $38,000.
Over $44,000 but not over $50,000	$20,232, plus 68 percent of excess over $44,000.
Over $50,000 but not over $60,000	$24,312, plus 69 percent of excess over $50,000.
Over $60,000 but not over $70,000	$31,212, plus 70 percent of excess over $60,000.
Over $70,000 but not over $80,000	$38,212, plus 74 percent of excess over $70,000.
Over $80,000 but not over $90,000	$45,612, plus 76 percent of excess over $80,000.
Over $90,000 but not over $100,000	$53,212, plus 78 percent of excess over $90,000.
Over $100,000 but not over $150,000	$61,012, plus 82 percent of excess over $100,000.

If the surtax net income is—	*The surtax shall be—*
Over $150,000 but not over $200,000	$102,012, plus 85 percent of excess over $150,000.
Over $200,000 but not over $300,000	$144,512, plus 88 percent of excess over $200,000.
Over $300,000	$232,512, plus 89 percent of excess over $300,000.

(2) *Taxable years beginning after December 31, 1953.* In the case of taxable years beginning after December 31, 1953, there shall be levied, collected, and paid for each taxable year upon the surtax net income of every individual who is the head of a household the surtax shown in the following table:

If the surtax net income is—	*The surtax shall be—*
Not over $2,000	17 percent of the surtax net income.
Over $2,000 but not over $4,000	$340, plus 18 percent of excess over $2,000.
Over $4,000 but not over $6,000	$700, plus 21 percent of excess over $4,000.
Over $6,000 but not over $8,000	$1,120, plus 23 percent of excess over $6,000.
Over $8,000 but not over $10,000	$1,580, plus 27 percent of excess over $8,000.
Over $10,000 but not over $12,000	$2,120, plus 29 percent of excess over $10,000.
Over $12,000 but not over $14,000	$2,700, plus 33 percent of excess over $12,000.
Over $14,000 but not over $16,000	$3,360, plus 36 percent of excess over $14,000.
Over $16,000 but not over $18,000	$4,080, plus 39 percent of excess over $16,000.
Over $18,000 but not over $20,000	$4,860, plus 40 percent of excess over $18,000.
Over $20,000 but not over $22,000	$5,660, plus 44 percent of excess over $20,000.
Over $22,000 but not over $24,000	$6,540, plus 46 percent of excess over $22,000.
Over $24,000 but not over $28,000	$7,460, plus 49 percent of excess over $24,000.
Over $28,000 but not over $32,000	$9,420, plus 51 percent of excess over $28,000.
Over $32,000 but not over $38,000	$11,460, plus 55 percent of excess over $32,000.
Over $38,000 but not over $44,000	$14,760, plus 59 percent of excess over $38,000.
Over $44,000 but not over $50,000	$18,300, plus 63 percent of excess over $44,000.
Over $50,000 but not over $60,000	$22,080, plus 65 percent of excess over $50,000.
Over $60,000 but not over $70,000	$28,580, plus 68 percent of excess over $60,000.
Over $70,000 but not over $80,000	$35,380, plus 71 percent of excess over $70,000.
Over $80,000 but not over $90,000	$42,480, plus 73 percent of excess over $80,000.
Over $90,000 but not over $100,000	$49,780, plus 77 percent of excess over $90,000.
Over $100,000 but not over $150,000	$57,480, plus 80 percent of excess over $100,000.
Over $150,000 but not over $200,000	$97,480, plus 84 percent of excess over $150,000.
Over $200,000 but not over $300,000	$139,480, plus 87 percent of excess over $200,000.
Over $300,000	$226,480, plus 88 percent of excess over $300,000.

(3) *Definition of head of household.* For the purposes of this chapter, an individual shall be considered a head of a household if, and only if, such individual is not married at the close of his taxable year and maintains as his home a household which constitutes for such taxable year the principal place of abode, as a member of such household, of:

(A) A son, stepson, daughter, or stepdaughter of the taxpayer, or a descendant of a son or daughter of the taxpayer, but if such son, stepson, daughter, stepdaughter, or descendant is married at the close of the taxpayer's taxable year, only if the taxpayer is entitled to an exemption for the taxable year for such person under section 25 (b); or

(B) Any other person who is a dependent of the taxpayer, if the taxpayer is entitled to an exemption for the taxable year for such person under section 25 (b).

An individual shall be considered as maintaining a household only if over half of the cost of maintaining the household during the taxable year is furnished by such individual.

(4) *Determination of status.* For the purposes of this subsection—

(A) A legally adopted child of a person shall be considered a child of such person by blood;

(B) An individual who is legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married;

(C) A taxpayer shall be considered as not married at the close of his taxable year if at any time during the taxable year his spouse is a nonresident alien; and

(D) A taxpayer shall be considered as married at the close of his taxable year if his spouse (other than a spouse described in subparagraph (C)) died during the taxable year.

(5) *Nonresident alien.* For the purposes of this chapter a taxpayer shall in no case be considered a head of a household if at any time during the taxable year he is a nonresident alien.

(d) *Tax in case of joint return.* In the case of a joint return of husband and wife under section 51 (b), the combined normal tax and surtax under section 11 and subsection (b) of this section shall be twice the combined normal tax and surtax that would be determined if the net income and the applicable credits against net income provided by section 25 were reduced by one-half.

(e) *Computation of tax without regard to credits against tax.* In the application of this section, the combined normal tax and surtax shall be computed without regard to the credits provided in sections 31, 32, and 35.

(f) *Limitation on tax*—(1) *Calendar year 1951.* * * * [Not applicable.]

(2) *Taxable years beginning after October 31, 1951, and before January 1, 1954.* In the case of taxable years beginning after October 31, 1951, and before January 1, 1954, the combined normal tax and surtax shall in no event exceed 88 per centum of the net income of the taxable year.

(3) *Taxable years beginning after December 31, 1953.* In the case of taxable years beginning after December 31, 1953, the combined normal tax and surtax shall in no event exceed 87 per centum of the net income for the taxable year.

(g) *Cross references*—(1) *Alternative tax.* For alternative tax which may be elected if adjusted gross income is less than $5,000, see Supplement T.

(2) *Tax in case of capital gains.* For rate and computation of alternative tax in lieu of normal tax and surtax in the case of capital gain from the sale or exchange of capital assets held for more than 6 months, see section 117 (c).

(3) *Tax on personal holding companies.* For surtax on personal holding companies, see section 500.

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

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

(6) *Tax on self-employment income.* For tax on self-employment income, see subchapter E.

[Sec. 12 as amended by sec. 2, Rev. Act 1940; secs. 101, 102 (b) (2), Rev. Act 1941; secs. 103, 150 (j), Rev. Act 1942; Sec. 4 (a) (b), Individual Income Tax Act 1944; sec. 101 (b) (c), Rev. Act 1945; secs. 101, 104 (b) (c), 301, Rev. Act 1948; sec. 101 (b), Rev. Act 1950; sec. 208 (d) (2), Social Security Act Amendments 1950; secs. 101, 301 (a), Rev. Act 1951]

§ 39.12–1 *Surtax on individuals.* (a) There is imposed, in addition to the normal tax imposed by section 11, a surtax determined as 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 net income minus the credits provided in section 25 (b) The surtax shall be determined in accordance with the applicable surtax table contained in section 12 (b) (2) or (3) For treatment of taxable years beginning in 1953 and ending in 1954, see § 39.108–1.

(b) The surtax for any amount of surtax net income is computed by adding to the surtax for the bracket in which that amount falls in the table in section 12 (b) the surtax upon the excess of that amount over the bottom of the bracket at the rate indicated in the table. Accordingly, the surtax for taxable years beginning after December 31, 1953, upon a surtax net income of $63,128 would be $34,866, computed as follows:

Surtax on $60,000 from table	$32,520
Surtax on $3,128 at 75 percent	2,346
Total	34,866

(c) For computation of tax in the case of a joint return of husband and wife, see § 39.12–3.

(d) For tax treatment of head of household, see § 39.12–4.

§ 39.12–2 *Limitation on amount of tax.* The combined normal tax and surtax computed before the application thereto of the credit provided in section 31 (relating to the credit for foreign income tax) section 32 (relating to the credit for tax withheld at the source under section 143 or 144) and section 35 (relating to the credit for tax withheld on wages) shall not exceed an amount equal to the following percent of the taxpayer's net income for the taxable year:

	Percent
For taxable years beginning before Jan. 1, 1954	88
For taxable years beginning after Dec. 31, 1953	87

For treatment of taxable years beginning in 1953 and ending in 1954, see § 39.108–1.

§ 39.12–3 *Combined normal tax and surtax in case of joint return of husband and wife.* (a) In the case of a joint return of husband and wife (see section 51 (b)) the combined normal tax and surtax under section 11 and section 12 (b) shall be twice the combined normal tax and surtax that would be determined if the net income and the applicable credits against net income provided by section 25 were reduced by one-half. Section 12 (d) For method of computing gross income and adjusted gross income on a joint return, see § 39.51–1.

(b) The method of computing, under section 12 (d) the tax of husband and wife in the case of a joint return is as follows:

(1) First, the net income and applicable credits against net income are reduced by one-half. Second, the normal tax and surtax are determined as provided in sections 11 and 12 (b) by using the net income and applicable credits so reduced. Third, the normal tax and surtax so determined are aggregated. Fourth, this aggregate, which is the combined normal tax and surtax that would be determined if the net income and the applicable credits against net income provided by section 25 were reduced by one-half, is then multiplied by two, to produce the tax imposed in the case of the joint return.

(2) The limitation under section 12 (f) of the combined normal tax and surtax to an amount not in excess of a specified percent of the net income for the taxable year is to be applied before the fourth step above, that is, the limitation to be applied upon the combined normal tax and surtax is determined under section 12 (f) as the applicable specified percent of one-half of the net income for the taxable year (such one-half of the net income being the actual aggregate net income of the spouses reduced by one-half) For the percent applicable in determining the limitation under section 12 (f) of the combined normal tax and surtax, see § 39.12-2. After such limitation is applied, then the combined normal tax and surtax so limited is multiplied by two as provided in section 12 (d)

(3) The following computation illustrates the method of application of section 12 (d) in the determination of the tax of a husband and wife filing a joint return for the calendar year 1952. If the joint net income is $8,200 and the only allowable credits under section 25 are the two exemptions of the taxpayers under section 25 (b) (1) (A) the tax on the joint return for 1952 is $1,626, determined as follows:

1. Net income	$8,200
2. Net income reduced by one-half	4,100
3. Credits against net income under sec. 25 (2 exemptions under sec. 25 (b) (1) (A))	1,200
4. Credits in item 3 reduced by one-half	600
5. Net income reduced by one-half (item 2) minus credits reduced by one-half (item 4)	3,500
6. Normal tax computed under sec. 11 on amount in item 5 (3 percent of $3,500)	105
7. Surtax computed under sec. 12 (b) on amount in item 5 ($384 plus 21.6 percent of excess of $3,500 over $2,000)	708
8. Combined normal tax and surtax computed on net income and credits reduced by one-half	813
9. Twice the combined normal tax and surtax determined in item 8	1,626

(c) If the alternative tax is computed under section 117 (c) (2), relating to the alternative tax where a taxpayer (other than a corporation) has a net long-term capital gain in excess of a net short-term capital loss, the partial tax shall be computed under sections 11 and 12 as stated above but without inclusion of 50 percent of such excess in net income, and the total tax shall be such partial tax plus a specified percent of such excess (26 percent for taxable years beginning before November 1, 1953, and 25 percent for all other taxable years) as provided in such section 117 (c) (2)

(d) If a joint return of a husband and wife is filed under the provisions of section 51 (b) (3) if the husband and wife have different taxable years solely because of the death of either spouse, and if the taxable year of the surviving spouse covered by such joint return begins in 1953 and ends in 1954, the taxable year of the deceased spouse covered by the joint return shall, for the purpose of the computation under section 12 (d) and this section of the combined normal tax and surtax in respect of such joint return, be deemed to have ended on the date of the closing of the surviving spouse's taxable year.

(e) For computation of tax under Supplement T in the case of a joint return, see §§ 39.400-1 and 39.401-1.

(f) For treatment of taxable years beginning in 1953 and ending in 1954, see § 39.108-1.

§ 39.12-4 *Surtax in case of head of household*—(a) *General rule.* An individual who is the head of a household under the rules prescribed in section 12 (c) is subject to the surtax imposed by that section instead of the surtax imposed by section 12 (b) (2) and section 12 (b) (3)

(b) *Definition of head of household.* (1) For the purpose of section 12 (c), the taxpayer shall be considered the head of a household if, and only if, he is not married at the close of his taxable year and maintains as his home a household which constitutes for such taxable year the principal place of abode, as a member of such household, of at least one of the individuals specified in section 12 (c) (3) (A) or provided for in section 12 (c) (3) (B). Under no circumstances shall the same individual be used to qualify more than one taxpayer as the head of a household in the same taxable year.

(2) Section 12 (c) (3) (A) specifies that any of the following persons may be used to qualify the taxpayer as the head of a household: a son, stepson, daughter, stepdaughter, or a descendant of a son or daughter of the taxpayer. If, however, such person is married at the close of the taxable year of the taxpayer, the taxpayer may qualify as the head of a household by reason of such person only if the taxpayer is entitled to an exemption for his taxable year under section 25 (b) for such person, that is, only if such person has a gross income of less than $600 for the calendar year in which the taxable year of the taxpayer begins, if the taxpayer supplies more than one-half of the support of such person for such calendar year, and if such person does not make a joint return with his spouse for the taxable year beginning in such calendar year. For example, if such person is an unmarried son of the taxpayer, the taxpayer is not deprived of his status as the head of a household because the son has income of $600 or more for the calendar year in which the taxable year of the taxpayer begins; if, however, such son is married at the close of the taxable year of the taxpayer, the taxpayer still may qualify as the head of a household, but only if the gross income of the son is less than $600 for the calendar year in which the taxable year of the taxpayer begins and the other conditions for allowance of the dependency credit under section 25 (b) are met.

(3) Section 12 (c) (3) (B) provides that a person for whom the taxpayer is entitled to an exemption under section 25 (b) for the taxable year may be used to qualify the taxpayer as the head of a household. Section 25 (b) provides that the taxpayer may be entitled to an exemption for any of the following persons:

(i) His brother, sister, stepbrother, or stepsister;

(ii) His father or mother, or an ancestor of either;

(iii) His stepfather or stepmother;

(iv) A son or a daughter of his brother or sister;

(v) A brother or sister of his father or mother; or

(vi) His son-in-law, daughter-in-law, mother-in-law, father-in-law, sister-in-law, or brother-in-law,

if such person has a gross income of less than $600 for the calendar year in which the taxable year of the taxpayer begins, if the taxpayer supplies more than one-half of the support of such person for such calendar year and if such person does not make a joint return with his spouse for the taxable year beginning in such calendar year. For example, an unmarried taxpayer who maintains a home for himself and his widowed mother may not qualify as the head of a household by reason of his maintenance of a home for his mother if his mother has income of $600 or more in the calendar year in which the taxable year of the taxpayer begins, or if he does not furnish more than one-half of the support of his mother for such calendar year.

(4) For the purposes of this section, a taxpayer shall be considered as not married if at the close of his taxable year he is legally separated from his spouse under a decree of divorce or separate maintenance, or if at any time during the taxable year the spouse to whom the taxpayer is married at the close of his taxable year was a nonresident alien. A taxpayer shall be considered married at the close of his taxable year if his spouse (other than a spouse who is a nonresident alien) dies during such year.

(c) *Household.* Section 12 (c) is applicable only where the household actually constitutes the home of the taxpayer for his taxable year and also constitutes the principal place of abode of at least one other person specified in section 12 (c) (3) (A) or provided for in section 12 (c) (3) (B) for such taxable year, without regard to the fact that the physical location of such household may have changed during such taxable year. It is not sufficient that the taxpayer maintain the household without being its occupant. The taxpayer and

such other person must occupy the household for the entire taxable year of the taxpayer. They will be considered as occupying the household for such entire taxable year notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which a child or stepchild is absent for less than six months in the taxable year of the taxpayer, shall be considered a temporary absence due to special circumstances. Such absence will not prevent the taxpayer from qualifying as the head of a household if (1) it is reasonable to assume that the taxpayer or such other person will return to the household, and (2) the taxpayer continues to maintain such household or a substantially equivalent household in anticipation of such return. The taxpayer will not be deprived of the benefits of section 12 (c) because such other person dies during the taxable year of the taxpayer if the household constitutes the principal place of abode of such other person during that part of such taxable year preceding death.

(d) *Cost of maintaining a household.* The taxpayer shall be considered as maintaining a household only if he pays more than one-half the cost thereof for his taxable year. The cost of maintaining a household shall be the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants for such taxable year. Such expenses include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. The cost of maintaining a household shall not include expenses otherwise incurred. Thus, such cost does not include expenses incurred for clothing, education, medical treatment, vacations, life insurance, and transportation. In addition, the cost of maintaining a household shall not include any amount which represents the value of services rendered in the household by the taxpayer or by a person specified in section 12 (c) (3) (A) or provided for in section 12 (c) (3) (B)

§ 39.13 *Statutory provisions; normal tax on corporations.*

SEC. 13. *Normal tax on corporations*—(a) *Definitions.* For the purposes of this chapter—

(1) *Adjusted net income.* 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.

(2) *Normal-tax net income.* The term "normal-tax net income" means the adjusted net income minus the sum of the following credits:

(A) The credit for dividends received provided in section 26 (b);

(B) In the case of a public utility, the credit for dividends paid on its preferred stock provided in section 26 (h); and

(C) In the case of a western hemisphere trade corporation (as defined in section 109), the credit provided in section 26 (i).

(b) *Imposition of tax.* There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every corporation (except a corporation subject to a tax imposed by section 231 (a), Supplement G, or Supplement Q)—

(1) *Calendar year 1951.* * * * [Not applicable.]

(2) *Taxable years beginning after March 31, 1951, and before April 1, 1954.* In the case of taxable years beginning after March 31, 1951, and before April 1, 1954, a tax of 30 per centum of the normal-tax income.

(3) *Taxable years beginning after March 31, 1954.* In the case of taxable years beginning after March 31, 1954, a tax of 25 per centum of the normal-tax net income.

(c) *Exempt corporations.* For corporations exempt from taxation under this chapter, see section 101.

(d) *Tax on personal holding companies.* For surtax on personal holding companies, see section 500.

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

(f) *Mutual savings banks conducting life insurance business.* For special tax, in lieu of the taxes imposed by this section and section 15, in the case of a mutual savings bank conducting a life insurance business, see section 110.

[Sec. 13 as amended by sec. 201, Rev. Act 1939; sec. 3, Rev. Act 1940; sec. 101 (a), Second Rev. Act 1940; sec. 103 (a), Rev. Act 1941; sec. 105 (a), Rev. Act 1942; sec. 122 (g) (2), Rev. Act 1945; sec. 121, Rev. Act 1950; secs. 121 (a), 346 (b), Rev. Act 1951]

§ 39.13–1 *Tax on corporations in general.* (a) Section 13 imposes an income tax on corporations generally. Every corporation is liable to the tax imposed by such section, except (1) corporations expressly exempt from all taxation under chapter 1 (see section 101) (2) corporations subject to tax under Supplement U (see section 421) (3) foreign corporations not engaged in trade or business within the United States (see section 231 (a)) (4) insurance companies (see Supplement G) and (5) regulated investment companies (see Supplement Q)

(b) 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 for a taxable year is computed upon the "normal-tax net income" for the taxable year, that is, the adjusted net income for such year minus (1) the credit for dividends received provided in section 26 (b) for such year, (2) in the case of a public utility, the credit for dividends paid on its preferred stock provided in section 26 (h) for such year, and (3) in the case of a Western Hemisphere trade corporation (see section 109) the credit provided in section 26 (i) for such year. For taxable years beginning before April 1, 1954, and ending after March 31, 1954, see § 39.108–2. The "adjusted net income" of a corporation 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.

(c) The tax imposed by section 13 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 3797 (a) For treatment of the tax imposed on foreign corporations engaged in trade or business within the United States, see § 39.231–1 (c) In the case of foreign corporations not engaged in trade or business within the United States, the tax is as provided in section 231 (a) In the case of insurance companies, the tax is as provided in Supplement G (sections 201 to 207, inclusive) In the case of regulated investment companies, the tax is as provided in Supplement Q (sections 361 and 362) In the case of corporations subject to tax under Supplement U, the tax is as provided in sections 421 to 424, inclusive. For surtax on corporations generally, see § 39.15–1. For surtax on personal holding companies, see sections 500 to 511, inclusive. For surtax on corporations improperly accumulating surplus, see section 102. For treatment of capital gains and losses, see section 117. For treatment of mutual savings banks conducting life insurance business, see section 110.

(d) (1) The tax imposed by section 13 is computed by applying to the "normal-tax net income" the rate in effect for the taxable year. The rates of tax under section 13 applicable for the respective taxable years are as follows:

	Percent
For taxable years beginning before April 1, 1954	30
For taxable years beginning after March 31, 1954	25

(2) The computation of the tax under section 13 may be illustrated by the following example:

Example. The A Corporation, a domestic corporation (which is neither a public utility referred to in section 26 (h) nor a Western Hemisphere trade corporation referred to in section 26 (i)), has for the calendar year 1952 a net income of $130,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $10,000 and cash dividends received (allowable as a credit under section 26 (b) (1)) in the amount of $10,000. The corporation's tax under section 13 for the calendar year 1952 is $32,050.25, computed as follows:

Net income	$130,000
Less credit for interest on United States obligations	10,000
Adjusted net income	120,000
Less credit for dividends received (85 percent of $10,000)	8,500
Normal-tax net income	111,500
Tax under sec. 13 (b) (2) (30 percent of $111,500)	33,450

§ 39.14–15 *Statutory provisions; tax on special classes of corporations; surtax on corporations.*

SEC. 14. *Tax on special classes of corporations in case of taxable years (other than the calendar year 1950) beginning before July 1, 1950.*

[Repealed by sec. 121 (g), Rev. Act 1951.]

SEC. 15. *Surtax on corporations*—(a) *Corporation surtax net income.* For the purposes of this chapter, the term "corporation surtax net income" means the net income minus the sum of the following credits:

(1) The credit for dividends received provided in section 26 (b);

(2) In the case of a public utility, the credit for dividends paid on its preferred stock provided in section 26 (h);

(3) In the case of a western hemisphere trade corporation (as defined in section 109), the credit provided in section 26 (i).

(b) *Imposition of tax.* There shall be levied, collected, and paid for each taxable year upon the corporation surtax net income of every corporation (except a corporation subject to a tax imposed by section 231 (a), Supplement G, or Supplement Q) a surtax of 22 per centum of the amount of the corporation surtax net income in excess of $25,000.

(c) *Disallowance of surtax exemption and minimum excess profits credit.* If any corporation transfers, on or after January 1, 1951, all or part of its property (other than money) to another corporation which was created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor corporation or its stockholders, or both, are in control of such transferee corporation during any part of the taxable year of such transferee corporation, then such transferee corporation shall not for such taxable year (except as may be otherwise determined under section 129 (b)) be allowed either the $25,000 exemption from surtax provided in subsection (b) or the $25,000 minimum excess profits credit provided in the last sentence of section 431, unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer. For the purposes of this subsection, 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 or at least 80 per centum of the total value of shares of all classes of stock of the corporation. In determining the ownership of stock for the purpose of this subsection, the ownership of stock shall be determined in accordance with the provisions of section 503, except that constructive ownership under section 503 (a) (2) shall be determined only with respect to the individual's spouse and minor children. The provisions of section 129 (b), and the authority of the Secretary under such section, shall, to the extent not inconsistent with the provisions of this subsection, be applicable to this subsection. This subsection shall not apply to any taxable year with respect to which the tax imposed by subchapter D of this chapter is not in effect.

[Sec. 15 as amended by sec. 104 (a), Rev. Act 1941; sec. 105 (b), Rev. Act 1942; secs. 121 (a), 122 (g) (3), Rev. Act 1945; sec. 121 (c), Rev. Act 1950; sec. 201 (a) (e), Excess Profits Tax Act 1950; sec. 121 (f) Rev. Act 1951]

§ 39.15-1 *Surtax on corporations.* (a) Section 15 imposes a surtax upon the corporation surtax net income of every corporation, except (1) corporations expressly exempt from all taxation under chapter 1 (see section 101) (2) corporations subject to tax under Supplement U (see section 421) (3) foreign corporations not engaged in trade or business within the United States (see section 231 (a)) (4) insurance companies (see Supplement G) and (5) regulated investment companies (see Supplement Q) For surtax on personal holding companies, see sections 500 to 511, inclusive. For surtax on corporations improperly accumulating surplus, see section 102. For treatment of capital gains and losses, see section 117. For treatment of mutual savings banks conducting life insurance business, see section 110.

(b) The "corporation surtax net income" of a corporation is its net income for the taxable year minus (1) the credit for dividends received provided in section 26 (b) for such year, (2) in the case of a public utility, the credit for dividends paid on its preferred stock provided in section 26 (h) for such year, and (3) in the case of a Western Hemisphere trade corporation (see section 109) the credit provided in section 26 (i) for such year. The credit provided in section 26 (a) for interest received on obligations of the United States or its instrumentalities is not allowable in computing corporation surtax net income for any taxable year.

(c) The surtax on corporations is at the rate of 22 percent and is upon corporation surtax net income in excess of $25,000. See, however, § 39.15-2, as to the circumstances under which the $25,000 exemption from surtax for certain taxable years may be disallowed in whole or in part.

(d) For treatment of taxable years beginning before April 1, 1954, and ending after March 31, 1954, see § 39.108-2.

(e) The computation of the surtax on corporations may be illustrated by the following example:

Example. The A Corporation, a domestic corporation (which is neither a public utility referred to in section 26 (h) nor a Western Hemisphere trade corporation referred to in section 26 (i)), has for the calendar year 1952 a net income of $86,000. The net income includes cash dividends received from a corporation (allowable as a credit under section 26 (b) (1)) in the amount of $10,000, and interest on United States obligations (allowable as a credit under section 26 (a) in determining adjusted net income for purposes of corporation normal tax) in the amount of $10,000. The A Corporation's surtax for the calendar year 1952 is $11,550, computed as follows:

Net income	$86,000
Less credit for dividends received (85 percent of $10,000)	8,500
Corporation surtax net income	77,500
Surtax (22 percent of $52,500, the excess of $77,500 over $25,000)	11,550

§ 39.15-2 *Disallowance of surtax exemption and minimum excess profits credit*—(a) *In general.* If one corporation transfers after December 31, 1950, all or part of its property (other than money) to another corporation, neither the $25,000 exemption from surtax provided in section 15 (b) nor the $25,000 minimum excess profits credit provided in section 431 shall be allowed the transferee if:

(1) The transferee was created for the purpose of acquiring such property, or

(2) The transferee was not actively engaged in business at the time of the acquisition, and

(3) After such transfer the transferor or its stockholders, or both, are in control of the transferee during any part of the taxable year of the transferee,

unless—

(4) The transferee establishes by the clear preponderance of the evidence that the securing of either such exemption or such credit or both was not a major purpose of such transfer, or

(5) The Commissioner allows such exemption or such credit pursuant to the authority provided in section 15 (c) and section 129 (b).

(b) *Purpose of section 15 (c)* (1) The purpose of section 15 (c) is to prevent avoidance or evasion of the surtax on corporation surtax net income imposed by section 15 (b) or of the excess profits tax imposed by section 430. It is not intended, however, that section 15 (c) be interpreted as delimiting or abrogating any principle of law established by judicial decision, or any existing provisions of the Internal Revenue Code, such as sections 45 and 129, which have the effect of preventing the avoidance or evasion of income or excess profits taxes. Such principles of law and such provisions of the Code, including section 15 (c) are not mutually exclusive, and in appropriate cases they may operate together or they may operate separately.

(2) The provisions of section 129 (b) and the authority of the Commissioner thereunder, to the extent not inconsistent with the provisions of section 15 (c), are applicable to cases covered by section 15 (c). Pursuant to the authority provided in section 129 (b) the Commissioner may allow to the transferee any part of a surtax exemption or minimum excess profits credit for a taxable year for which such exemption or credit would otherwise be disallowed under section 15 (c), or he may apportion such exemption or credit among the corporations involved (see § 39.129-4). For example, Corporation A transfers on January 1, 1952, all its property to Corporations B and C in exchange for all the stock of such corporations. Immediately thereafter, Corporation A is dissolved and its stockholders become the sole stockholders of Corporations B and C. Assuming that Corporations B and C are unable to establish by the clear preponderance of the evidence that the securing of the surtax exemption provided in section 15 (b) or the minimum excess profits credit provided in section 431, or both, was not a major purpose of the transfer, the Commissioner, nevertheless, has authority under sections 15 (c) and 129 (b) to allow one such exemption and credit and to apportion such exemption and credit between Corporations B and C.

(3) For the purpose of section 15 (c) and this section, a corporation maintaining an office for the purpose of preserving its corporate existence is not considered to be "actively engaged in business" even though such corporation may be deemed to be "doing business" for other purposes. Similarly, for the purpose of section 15 (c) and this section, a corporation engaged in winding up its affairs, prior to an acquisition to

which section 15 (c) is applicable, is not considered to be "actively engaged in business"

(c) *Meaning and application of the term "control"* For the purpose of section 15 (c) and this section, the term "control" means the ownership of stock possessing either (1) at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or (2) at least 80 percent of the total value of shares of all classes of stock of the corporation. In determining whether stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote is owned, all classes of such stock shall be considered together; it is not necessary that 80 percent of each class of voting stock be owned. Likewise, in determining whether stock possessing at least 80 percent of the total value of shares of all classes of stock is owned, all classes of stock of the corporation shall be considered together; it is not necessary that 80 percent of the value of shares of each class be owned. The fair market value of a share shall be considered as the value to be used for the purpose of this computation. The ownership of stock shall be determined in accordance with the provisions of section 503 and the regulations thereunder, except that constructive ownership under section 503 (a) (2) shall be determined only with respect to the individual's spouse and minor children. For example, in addition to stock held directly or under an option to purchase, an individual is deemed to own stock held directly or indirectly by or for his spouse or minor children, and also to own a proportionate part of the stock owned by a corporation, partnership, estate, or trust in which he holds an interest as a shareholder, partner, or beneficiary.

Disallowance of the exemption and credit under section 15 (c) is not limited to the taxable year of the transferee corporation in which the transfer of property occurs. Section 15 (c) provides for the disallowance of the exemption and credit for any taxable year whether the taxable year in which the transfer of property occurs or any subsequent taxable year of the transferee corporation, if, during any part of such year, the transferor corporation or its stockholders, or both, are in control of the transferee corporation. Thus, if Corporation D on January 1, 1952, transfers a part of its property to Corporation E, a corporation not actively engaged in business at the time of the acquisition of such property, in exchange for 60 percent of the voting stock of Corporation E, and; thereafter, during a later taxable year with respect to which section 15 (c) is applicable, acquires an additional 20 percent of the voting stock of Corporation E, Corporation D, by reason of such later acquisition, is considered to be in control of Corporation E as of the time of such acquisition for the purpose of section 15 (c) Accordingly, Corporation E will be disallowed the surtax exemption and minimum excess profits credit for the taxable year in which the later acquisition of stock occurred and for each taxable year thereafter in which the requisite control continues, unless Corporation E establishes by the clear preponderance of the evidence that the securing of such exemption or credit, or both, was not a major purpose of the transfer of the property in 1952.

In determining, for the purpose of section 15 (c) whether a corporation, its stockholders, or both, are in control of a transferee corporation, it is not necessary that the stock be acquired on or after January 1, 1951. Thus, if Corporation F on June 1, 1950, owns 70 percent of the voting stock of Corporation G, and, thereafter, on January 2, 1952, Corporation F acquires an additional 10 percent of such stock, control within the meaning of section 15 (c) is acquired by Corporation F on January 2, 1952.

(d) *Nature of transfer* A transfer made by any corporation of all or part of its assets, whether or not such transfer qualifies as a reorganization under section 112 (g) is within the scope of section 15 (c) except that section 15 (c) does not apply to a transfer of money only. For example, the transfer of cash for the purpose of expanding the business of the transferor corporation through the formation of a new corporation is not a transfer within the scope of section 15 (c) irrespective of whether the new corporation uses the cash to purchase from the transferor corporation stock in trade or similar property.

(e) *Purpose of transfer* In determining, for the purpose of section 15 (c) whether the securing of the exemption from surtax or the minimum excess profits credit constituted "a major purpose" of the transfer, all circumstances relevant to the transfer shall be considered. For disallowance of the surtax exemption and minimum excess profits credit under section 15 (c) it is not necessary that the obtaining of either such credit or exemption or both have been the sole or principal purpose of the transfer of the property. It is sufficient if it appears, in the light of all the facts and circumstances, that the obtaining of such exemption or credit, or both, was one of the major considerations that prompted the transfer. Thus, the securing of the surtax exemption or the minimum excess profits credit may constitute "a major purpose" of the transfer, notwithstanding that such transfer was effected for a valid business purpose and qualified as a reorganization within the meaning of section 112 (g) The taxpayer's burden of establishing by the clear preponderance of the evidence that the securing of either such exemption or credit or both was not "a major purpose" of the transfer may be met, for example, by a showing that the obtaining of such exemption, or credit, or both, was not a major factor in relationship to the other consideration or considerations which prompted the transfer.

(f) *Taxable years to which applicable.* Section 15 (c) and this section do not apply to any taxable year with respect to which the excess profits tax imposed by subchapter D of chapter 1 of the Internal Revenue Code is not in effect. For treatment of taxable years beginning before April 1, 1954, and ending after March 31, 1954, see § 39.108-2. For computation of the excess profits tax for certain fiscal years, see § 40.430-2 (b) (2) and (c) of Regulations 130 (Part 40 of this chapter)

COMPUTATION OF NET INCOME

§ 39.21 *Statutory provisions; net income.*

SEC. 21. *Net income*—(a) *Definition.* "Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

(b) *Cross references.* For definition of "adjusted net income" and "normal-tax net income," see section 13.

[Sec. 21 as amended by sec. 210 (a), Rev. Act 1939]

§ 39.21-1 *Meaning of net income.* (a) The tax imposed by chapter 1 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:

(1) 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 Internal Revenue Code 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.)

(2) Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by chapter 1. (See section 22.)

(3) 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.)

(4) Net income less certain credits. (See sections 25, 26, 27, and 28.)

(b) 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.)

(c) 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, 122, 203, 204, 207, 232, and 336, and sections 500 to 511, inclusive.)

§ 39.22 (a) *Statutory provisions; definition of gross income.*

SEC. 22. *Gross income*—(a) *General definition.* "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), 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. In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income.

[Sec. 22 (a) as amended by secs. 1, 3, Public Salary Tax Act 1939]

§ 39.22 (a)-1 *What included in gross income.* (a) 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 to 238, inclusive, 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.

(b) If property is transferred by a corporation to a shareholder, for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, such shareholder 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 a distribution of earnings or profits taxable as a dividend. 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 § 39.22 (a)-8.

(c) Except as otherwise provided in section 130A, if property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee. 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. See section 130A and the regulations prescribed thereunder for special rules with respect to stock transferred from an employer to an employee pursuant to the timely exercise of a restricted stock option.

(d) 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.

(e) 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 to 113, inclusive. As to amounts received as loans from the Commodity Credit Corporation, see section 123. As to income upon a recovery in respect of war losses, see section 127 (c). As to insurance companies and foreign corporations, see sections 201 to 207, inclusive, and section 231.

§ 39.22 (a)-2 *Compensation for personal services.* (a) 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 the United States (unless expressly exempt) or by private persons 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.

(b) The salaries of Federal officers and employees are subject to tax. Amounts deducted and withheld pursuant to the Civil Service Retirement Act of May 29, 1930 (5 U. S. C., c. 14), from the basic salary, pay, or compensation of the employees in the civil service of the United States are includible in gross income for the year in which deducted and withheld. As used in this section, the term "Federal officers and employees" includes all judges of courts of the United States irrespective of when they took office. Compensation received for services rendered as an officer or employee (including a member of a legislative body and a judge or officer of a court) of a State or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing, is to be included in gross income, regardless of the nature of the office or employment.

(c) The value of services need not be included in gross income when rendered directly and gratuitously to an organization described in section 23 (o) Where, however, pursuant to an agreement or understanding services are rendered to a person for the benefit of an organization described in section 23 (o) and an amount for such services is paid to such organization by the person to whom the services are rendered, the amount so paid constitutes income to the person performing the services even though at the time of the agreement or understanding the person making the payment acknowledges his liability to make payment to such organization.

§ 39.22 (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 a person receives as compensation for services rendered a salary and in addition thereto living quarters or meals, the value to such person of the quarters and meals so furnished constitutes income subject to tax. If, however, living quarters or meals are furnished to employees for the convenience of the employer, the value thereof need not be computed and added to the compensation otherwise received by the employees. The value of quarters furnished to the commissioned officers, chief warrant officers, warrant officers, and enlisted personnel of the Army, Navy, Air Force, 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 § 39.24 (a)-3.

§ 39.22 (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.

§ 39.22 (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 gross income, subtractions should not be made for depletion allowances based on discovery value or percentage of income, selling expenses, or losses, or for other items not ordinarily used in computing cost of goods sold. But see § 39.23 (m)-1 (e)

§ 39.22 (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.

§ 39.22 (a)-7 *Gross income of farmers.* (a) 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 livestock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any livestock or other items which were purchased, and (3) gross income from all other sources. The profit from the sale of livestock 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.

(b) 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 livestock and products on hand at the end of the year the amount received from the sale of livestock 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 livestock and products on hand at the beginning of the year and the cost of livestock and products purchased during the year. In such cases all livestock 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 livestock 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 livestock 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 § 39.22 (c)-6.

(c) In the case of the sale of machinery, farm equipment, or any other property (except stock in trade of the taxpayer, or 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) any excess of the proceeds of the sale over the adjusted basis of such property determined under section 113 and the regulations thereunder shall be included in the taxpayer's gross income for the taxable year in which such sale is made. 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 § 39.41-2) 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.

(d) As used in this section, 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.

(e) 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 §§ 39.23 (a)-11, 39.23 (e)-5, and 39.23 (l)-10.)

§ 39.22 (a)-8 *Sale of stock and rights.* (a) 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 cannot 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 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. With respect to the basis for determining gain or loss from the sale or other disposition of stock acquired as a stock dividend or the stock with respect to which the stock dividend was acquired, see §§ 39.113 (a) (19)-1 and 39.113 (a) (19)-2. 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.

(b) 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 acquired stock subscription rights which did not constitute income to the shareholders within the meaning of the sixteenth amendment to 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, properly adjusted, of the stock in respect of which the rights are acquired 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, properly adjusted, assigned to the rights or the stock, divided, as the case may be, by the number of rights acquired or by the number of shares held.

Example. A taxpayer in 1947 purchased 500 shares of common stock at $125 a share, and in 1952, by reason of the ownership of such stock, acquired 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 acquired

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 at follows:

500 (shares) ×$125=$62,500, cost of old stock (stock in respect of which the rights were acquired).

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.

$\frac{1,500}{61,500}$ 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 acquired, 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 acquired shall be determined as in subparagraph (1) of this paragraph. 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, properly adjusted, of the old shares assigned to the rights, plus the subscription price of the new shares, by the number of new shares acquired.

Example. A taxpayer in 1949 purchased 500 shares of common stock at $125 a share, and in 1952, by reason of the ownership of such stock, acquired 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 acquired 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 subparagraph (1) of this paragraph)+$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 acquired is $60,975.61—500, or $121.95 a share.

(3) If the stock in respect of which the rights are acquired 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 acquired was purchased at different times or at different prices and the stock rights acquired in respect of such stock cannot be identified as having been acquired in respect of any particular lot of such stock, the basis for determining the gain or loss from the sale or other disposition of the old shares, or the rights in cases in which the rights are sold, or from the sale or other disposition of the old or new shares in cases in which the rights are exercised, shall be ascertained in accordance with the principles laid down in § 39.113 (a) (12)-1.

(c) *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* § 39.23 (e)-1.

§ 39.22 (a)-9 *Sale of patents and copyrights.* A taxpayer disposing of patents or coprights 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 §§ 39.111-1, 39.113 (a) (14)-1, and 39.113 (b) (1)-1 to 39.113 (b) (4)-1, inclusive.

§ 39.22(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 §§ 39.111-1, 39.113 (a) (14)-1, and 39.113 (b) (1)-1 to 39.113 (b) (4)-1, inclusive.) 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.

§ 39.22 (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.

§ 39.22 (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 § 39.22 (b) (2)-2. An annuity charged upon devised land is taxable to the donee-annuitant to the extent it becomes payable out of the rents or other income of the land, whether or not it is a charge upon the income of the land. See section 22 (b) (3) and § 39.22 (b) (3)-1. As to certain cases in which an annuity charged upon devised land is taxable in full to a spouse upon divorce or legal separation, see section 22 (k). 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.

§ 39.22 (a)-13 *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 § 39.22 (a)-17. 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. For exclusion from gross income of income attributable to discharge of indebtedness of certain corporations, see § 39.22 (b) (9)-1. For exclusion from gross income of income attributable to discharge of indebtedness of railroad corporations in certain judicial proceedings, see § 39.22 (b) (10)-1. For exclusion from gross income of income attributable to the forgiveness or discharge of a grant or loan made to a taxpayer by the United States for the encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, see § 39.22 (b) (15)-1.

(b) *Proceedings under Bankruptcy Act.* Income is not realized by a taxpayer by virtue of the discharge, under section 14 of the Bankruptcy Act (11 U. S. C. 32), 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, 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 Chapter X of the Bankruptcy Act (11 U. S. C., c. 10)

(2) an "arrangement" or a "real property arrangement" confirmed under Chapter XI or XII, respectively, of the Bankruptcy Act (11 U. S. C., c. 11, 12) or

(3) a "wage earner's plan" confirmed under Chapter XIII of the Bankruptcy Act (11 U. S. C., c. 13).

If, however, such plan of corporate reorganization or arrangement or wage

earner's plan referred to in subparagraphs (1) to (3) of this paragraph had for one of its principal purposes the avoidance of income tax, the cancellation or reduction of indebtedness, under such plan, confirmed under Chapter X, XI, XII, or XIII of the Bankruptcy Act (11 U. S. C., c. 10–13) may result in the realization of income.

(c) *Cross references.* For adjustment of basis of certain property in the case of cancellation or reduction of indebtedness resulting from a proceeding under the Bankruptcy Act, see §§ 39.113 (b) (1)–2 and 39.113 (b) (1)–3.

§ 39.22 (a)–14 *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.

§ 39.22 (a)–15 *Acquisition or disposition by a corporation of its own capital stock.* (a) Whether the acquisition 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.

(b) However, 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 Internal Revenue Code.

§ 39.22 (a)–16 *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 §§ 39.22 (a)–13 and 39.24 (a)–2.)

§ 39.22 (a)–17 *Sale and purchase by corporation of its bonds.* (a) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. 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. 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.

(b) 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. 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. 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.

(c) 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. 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. 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.

(d) 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. 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. 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.

(e) For exclusion from gross income of income attributable to discharge of indebtedness of certain corporations, see § 39.22 (b) (9)–1. For exclusion from gross income of income attributable to discharge of indebtedness of railroad corporations in certain judicial proceedings, see § 39.22 (b) (10)–1.

§ 39.22(a)–18 *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 to 113, inclusive. If the purchaser takes over all the assets and assumes the liabilities, the amount so assumed is part of the selling price.

§ 39.22(a)–19 *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 leased 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 for 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.

§ 39.22 (a)–20 *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 § 39.44-5. (See also § 39.52-2.)

§ 39.22 (a)-21 *Trust income taxable to the grantor as substantial owner thereof*—(a) *Introduction.* Income of a trust is taxable to the grantor under section 22 (a) although not payable to the grantor himself and not to be applied in satisfaction of his legal obligations if he has retained a control of the trust so complete that he is still in practical effect the owner of its income. (Helvering *v.* Clifford, 309 U. S. 331.) In the absence of precise guides supplied by an appropriate regulation, the application of this principle to varying and diversified factual situations has led to considerable uncertainty and confusion. The provisions of this section accordingly resolve the present difficulties of application by defining and specifying those factors which demonstrate the retention by the grantor of such complete control of the trust that he is taxable on the income therefrom under section 22 (a) Such factors are set forth in general in paragraph (b) of this section and in detail in paragraphs (c) (d) and (e) of this section.

(b) *In general.* In conformity with the principle stated in paragraph (a) of this section, the income of a trust is attributable to the grantor (except where such income is taxable to the grantor's spouse or former spouse under section 22 (k) or 171) if:

(1) The corpus or the income therefrom will or may return after a relatively short term of years (see paragraph (c) of this section)

(2) The beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition (other than certain excepted powers) whether by revocation, alteration, or otherwise, exercisable by the grantor, or another person lacking a substantial adverse interest in such disposition, or both (see paragraph (d) of this section) or

(3) The corpus or the income therefrom is subject to administrative control, exercisable primarily for the benefit of the grantor (see paragraph (e) of this section)

(c) *Reversionary interest after a relatively short term.* (1) Income of a trust is taxable to the grantor where the grantor has a reversionary interest in the corpus or the income therefrom which will or may reasonably be expected to take effect in possession or enjoyment:

(i) Within 10 years commencing with the date of the transfer, or

(ii) Within 15 years commencing with the date of the transfer if the income is or may be payable to a beneficiary other than a donee described in section 23 (o) and if any one or more of the following powers of administration over the trust corpus or income are exercisable solely by the grantor, or spouse (living with the grantor, and not having a substantial adverse interest in the corpus or income of the trust) or both, whether or not exercisable as trustee: a power to vote or direct the voting of stock or other securities, a power to control the investment of the trust funds either by directing investments or reinvestments or by vetoing proposed investments or reinvestments, and a power to reacquire the trust corpus by substituting other property, whether or not of an equivalent value.

(2) Where the grantor's reversionary interest is to take effect in possession or enjoyment by reason of some event other than the expiration of a specific term of years, the trust income is nevertheless attributable to him if such event is the practical equivalent of the expiration of a period less than 10 or 15 years, as the case may be. For example, a grantor is taxable on the income of a trust if the corpus is to return to him or his estate on the graduation from college or prior death of his son, who is 18 years of age at the date of the transfer in trust. Trust income is, however, not attributable to the grantor where such reversionary interest is to take effect in possession or enjoyment at the death of the person or persons to whom the income is payable.

(3) In general, a reversionary interest may reasonably be expected to take effect in possession or enjoyment within 10 or 15 years, as the case may be, where the corpus or the income therefrom is to be reacquired if the grantor survives any stated contingency which is of an insubstantial character. Thus, the grantor is taxable where the trust income is to be paid to the grantor's wife for three years, and the corpus is then to be returned to the grantor if he survives such period, or to be paid to the grantor's wife is he is already deceased.

(4) Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. But income for any period shall not be taxable to the grantor by reason of the preceding sentence if such income would not be taxable to him in the absence of such postponement. This may be illustrated by the following example:

Example. A places property in trust for the benefit of his son B. Upon the expiration of 12 years or the earlier death of B the property is to be paid over to A or his estate. Neither A nor his wife has any power of administration over the trust corpus or income. After the expiration of nine years A extends the term of the trust for an additional two years. A is considered to have made a new transfer in trust for a term of five years. He is not taxable on the income for the first three years of such term because he would not be taxable thereon if the term of the trust had not been extended. A is taxable, however, on the income for the remaining two years.

(d) *Power to determine or control beneficial enjoyment of income or corpus.* (1) Income of a trust is taxable to the grantor where, whatever the duration of the trust, the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition (except as provided in section 167 (c) and as hereafter provided in subdivisions (i) to (iv), inclusive, of subparagraph (2) of this paragraph) whether by revocation, alteration, or otherwise, exercisable (in any capacity and regardless of whether such exercise is subject to a precedent giving of notice or is limited to some future date) by the grantor, or any person not having a substantial adverse interest in the beneficial enjoyment of the corpus or income, whichever is subject to the power, or both. The grantor is not taxable, however, if the power, whether exercisable with respect to corpus or income, may only affect the beneficial enjoyment of the income for a period commencing 10 years from the date of the transfer (or 15 years where any power of administration specified in paragraph (c) of this section is exercisable solely by the grantor, or spouse living with the grantor and not having a substantial adverse interest, or both, whether or not as trustee) For example, if a trust created on January 1, 1945, provides for the payment of income to the grantor's wife, and the grantor does not reserve any such administrative power but reserves the power to substitute other beneficiaries in lieu of his wife on or after January 1, 1955, the grantor is not taxable on the trust income for the period before January 1, 1955. But the income will be attributable to the grantor for the period beginning on such date unless the power is relinquished. If the beginning of such period is postponed, such postponement is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. But income for any period shall not be taxable to the grantor by reason of the preceding sentence if such income would not be taxable to him in the absence of such postponement. Where the income affected by the power is for a period beginning by reason of some event other than the expiration of a specific term of years, the grantor will be taxable if such event is the practical equivalent of the expiration of a period less than 10 or 15 years, as the case may be, in accordance with the criteria stated in paragraph (c) of this section.

(2) The provisions of subparagraph (1) of this paragraph shall not apply to any one or more of the following powers:

(i) To a power exercisable only by will, other than a power in the grantor to appoint the income of the trust where the income is accumulated for such disposition by the grantor, or may be so accumulated in the discretion of the grantor, or any person not having a substantial adverse interest in the disposition of such income, or both. For example, if a trust provides that the income is to be accumulated during the grantor's life and that the grantor may appoint the accumulated income by will, the grantor is taxable on the trust income;

(ii) To a power to determine the beneficial enjoyment of the corpus or the income therefrom if such corpus or income, as the case may be, is irrevocably payable for the purposes and in the manner specified in section 23 (o)

(iii) To a power if such power is exercisable by a trustee or trustees, none of whom is the grantor, spouse living with the grantor, or a related or subordinate trustee of the type and under all the conditions referred to in subdivision (iv) (*b*) of this subparagraph, and the exercise of the power is not subject to the approval or consent of any person other than such trustee or trustees, and if such power is one:

(*a*) To distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries,

(*b*) To pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

The powers herein described include all the powers described in subdivision (iv) of this subparagraph, since the latter powers are more limited than those herein described.

(iv) To a power,

(*a*) Which is exercisable:

(*1*) By the grantor or spouse living with the grantor, or both, whether or not as trustee; or

(*2*) (*i*) Solely by a trustee or trustees who include the father, mother, issue, brother, sister or employee of the grantor, or a subordinate employee of a corporation in which the grantor is an executive or in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control and (*ii*) in a manner which may affect the interests of beneficiaries which include the spouse or any child of the grantor (see subdivision (iii) of this subparagraph for a power exercisable by a related or subordinate trustee of the class hereinabove described where the exercise of the power does not affect the interest of the spouse or a child of the grantor or where the power is exercisable only with the concurrence of an unrelated and nonsubordinate trustee) or

(*3*) By any person or persons other than as trustee; or

(*4*) By any trustee or trustees, and the exercise of the power is subject to the approval or consent of any person or persons (other than such trustee or trustees) or of the grantor or spouse living with the grantor, or both, in the capacity of trustee—and

(*b*) If such power is one:

(*1*) To pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite external standard. Such standard must be set forth in the trust instrument and must consist of needs and circumstances of the beneficiaries;

(*2*) To pay out corpus to or for any current income beneficiary, if the power is not limited by a reasonably definite external standard, provided that any such payment of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to such beneficiary as if such corpus constitutes a separate trust;

(*3*) To distribute or apply income to or for any current income beneficiary or to accumulate such income for him, provided that any accumulated income must ultimately be payable to the beneficiary from whom distribution or application is withheld, to his estate or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors or the creditors of his estate; or, if payable upon the termination of the trust or in conjunction with a distribution of corpus which distribution is augmented by such accumulated income, is ultimately payable to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument. Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which may reasonably be expected to occur within the beneficiary's lifetime, the share of such deceased beneficiary is to be paid to such persons as the beneficiary may appoint, or is to be paid to one or more designated alternate takers (other than the grantor or the grantor's estate) if the share of such alternate taker or the shares of such alternate takers have been irrevocably specified in the trust instrument;

(*4*) Exercisable only during (*i*) the existence of a legal disability of any current income beneficiary, or (*ii*) the period in which any income beneficiary shall be under the age of 21 years, to distribute or apply income to or for such beneficiary or to accumulate and add such income to corpus;

(*5*) In a case falling under (*a*) (*2*) of this subdivision, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions in (*b*) (*3*) or (*b*) (*4*) of this subdivision are satisfied, provided that such power is limited by a reasonably definite external standard. For the requirements of such standard, see (*b*) (*1*) of this subdivision.

A power does not fall within the powers described in subdivisions (iii) and (iv) of this subparagraph if the trustee is enabled to add to the class of beneficiaries designated to receive the income or corpus, except insofar as provision may be made for after-born or after-adopted children. A mere power to allocate receipts as between corpus and income, even though expressed in broad language, is not deemed a power over beneficial enjoyment with respect to income or corpus.

(e) *Administrative control.* (1) Income of a trust, whatever its duration, is taxable to the grantor where, under the terms of the trust or the circumstances attendant on its operation, administrative control is exercisable primarily for the benfit of the grantor rather than the benficiaries of the trust. Administrative control is exercisable primarily for the benefit of the grantor where:

(i) A power exercisable by the grantor, or any person not having a substantial adverse interest in its exercise, or both, whether or not in the capacity of trustee, enables the grantor or any person to purchase, exchange or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate and full consideration in money or money's worth; or

(ii) A power exercisable by the grantor, or any person not having a substantial adverse interest in its exercise, or both, whether or not in the capacity of trustee, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest in any case, or without adequate security except where a trustee (other than the grantor or spouse living with the grantor) is authorized under a general lending power to make loans without security to the grantor and other persons and corporations upon the same terms and conditions; or

(iii) The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year; or

(iv) Any one of the following powers of administration over the trust corpus or income is exercisable in a nonfiduciary capacity by the grantor, or any person not having a substantial adverse interest in its exercise, or both: a power to vote or direct the voting of stock or other securities, a power to control the investment of the trust funds either by directing investments or reinvestments or by vetoing proposed investments or reinvestments, and a power to reacquire the trust corpus by substituting other property of an equivalent value.

(2) If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Such presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether such power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration. For example, where the trust corpus consists of diversified stocks or securities of corporations the stock of which is not closely held and in which the holdings of the trust, either by themselves or in conjunction with the holdings of the grantor, are of no significance from the viewpoint of voting control, a power with respect to such stocks or securities held by a person who is not a trustee will be regarded as exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Where the trust corpus consists of stock or securities of a closely held corporation, such a power may or may not, depending upon all the facts, be considered exercisable in a fiduciary capacity.

(3) The mere fact that a power exercisable by the trustee is described in broad language does not indicate that the trustee is authorized to purchase, ex-

change, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

(f) *Limitations of section.* Despite the limitations of this section, the grantor of a trust directing the payment or application of the income therefrom in satisfaction of the grantor's legal obligations shall continue to be taxable on the income. The grantor may also be taxable on the income of a trust on the ground that such income is attributable to him in a capacity unrelated to dominion and control over the trust as such as defined in paragraphs (c) (d) and (e) of this section. Thus, the provisions of this section do not affect the principles governing the taxability of future income to the assignor thereof whether or not the assignment is by means of a trust. Nor, for example, do the provisions of this section affect the applicability of section 22 (a) to the creator of a family partnership. See also sections 166 and 167.

§ 39.22 (a)-22 *Trust income taxable to person other than grantor* Where a person other than the grantor of property transferred in trust has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, the income therefrom shall be included in computing the net income of such person. Even though such a power has been partially released or otherwise modified so that the person holding it can no longer vest the corpus or the income of the trust in himself, the income shall continue to be taxable to such person, if after such release or modification, he has retained such control of the trust as would, within the principles of § 39.22 (a)-21, subject a grantor of such a trust to tax on the income thereof. This section shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor is otherwise taxable under § 39.22 (a)-21. See also § 39.166-1.

§ 39.22 (a)-23 *Allocations by cooperative associations; tax treatment as to patrons*—(a) *In general.* Amounts allocated on the basis of the business done with or for a patron by a cooperative association, whether or not entitled to tax treatment under section 101 (12) (B) in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice or in some other manner disclosing to the patron the dollar amount allocated shall be included in the computation of the gross income of such patron for the taxable year in which received to the extent prescribed in paragraph (b) of this section, regardless of whether the amount allocated is deemed, for the purpose of section 101 (12) (B) to be made at the close of a preceding taxable year of the cooperative association. The determination of the extent of taxability of such amounts is in no way dependent upon the method of accounting employed by the patron or upon the basis, cash, accrual or otherwise, upon which the net income of such patron is computed.

(b) *Extent of taxability.* (1) Amounts allocated to a patron on a patronage basis by a cooperative association with respect to products marketed for such patron, or with respect to supplies, equipment, or services the cost of which was deductible by the patron under section 23, shall be included in the computation of the gross income of such patron to the following extent:

(i) If the allocation is in cash, in the amount of cash received.

(ii) If the allocation is in merchandise, to the extent of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of capital stock, revolving fund certificates, certificates of indebtedness, letters of advice, retain certificates or similar documents—

(*a*) To the extent of the face amount of such documents, if the allocation was made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated. For this purpose, it is immaterial whether such allocation was made within the time required by § 39.101 (12)-4 (a) (2)

(*b*) To the extent of the face amount of such documents, if the allocation was made with respect to patronage of a year preceding the taxable year from amounts retained as "reasonable reserves" under § 39.101-4 (a).

(*c*) To the extent of the cash or merchandise received in redemption or satisfaction of such documents (except those which are negotiable instruments) at the time of receipt of such cash or merchandise by the patron, where such allocation was not made in pursuance of the valid obligation referred to in subdivision (*a*) of this subparagraph, or from amounts retained as "reasonable reserves" under § 39.101 (12)-4 (a), referred to in subdivision (*b*) of this subparagraph. Where, in such case, the documents allocated are negotiable instruments, such documents shall be includible in the income of the patron to the extent of their fair market value at the time of their receipt.

(2) Amounts which are allocated on a patronage basis by a cooperative association with respect to supplies, equipment, or services the cost of which was not deductible by the patron under section 23, are not includible in the computation of the gross income of such patron; however, in the case of such amounts which are allocated with respect to capital assets (as defined in section 117 (a) (1)) or property used in the trade or business within the meaning of section 117 (j), shall, to the extent set forth in subdivisions (i), (ii) and (iii) of subparagraph (1) of this paragraph, be taken into account in determining under section 113 the cost or other basis of the assets or property purchased for the patron.

§ 39.22 (b) *Statutory provisions; exclusions from 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 chapter: * * *

§ 39.22 (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 may be excluded from gross income except (a) those items of income which are, under the Constitution, not taxable by the Federal Government; (b) those items of income which are exempt from tax on income under the provisions of any act of Congress still in effect; and (c) the income excluded under the provisions of the Internal Revenue Code (see particularly 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 Internal Revenue Code to be made from gross income in computing net income. As to other items not to be included in gross income, see sections 22 (k) 112, 119, 127 (c), 165, and 171 and Supplements G, H, I, and J (sections 201 to 252, inclusive) Section 607 (h) of the Merchant Marine Act, 1936, as amended, (46 U. S. C. 1177 (h)) reads as follows:

(h) The earnings of any contractor receiving an operating-differential subsidy under authority of this act, which are deposited in the contractor's reserve funds as provided in this section, except earnings withdrawn from the special reserve funds and paid into the contractor's general funds or distributed as dividends or bonuses as provided in paragraph 4 of subsection (c) of this section, shall be exempt from all Federal taxes. Earnings withdrawn from such special reserve fund shall be taxable as if earned during the year of withdrawal from such fund.

§ 39.22 (b) (1) *Statutory provisions; exclusions from gross income; life insurance.*

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 chapter:

(1) *Life insurance, etc., amounts received:*

(A) Under a life insurance contract, paid by reason of the death of the insured; or

(B) Under a contract of an employer providing for the payment of such amounts to the beneficiaries of an employee, paid by reason of the death of the employee;

whether in a single sum or otherwise (but if such amounts are held by the insurer, or the employer, under an agreement to pay interest thereon, the interest payments shall be included in gross income). The aggregate of the amounts excludible under subparagraph (B) by all the beneficiaries of the employee under all such contracts of any one employer may not exceed $5,000.

[Sec. 22 (b) (1) as amended by sec. 302 (a), Rev. Act 1951]

§ 39.22 (b) (1)-1 *Life insurance; amounts paid by reason of the death of the insured.* The proceeds of life insur-

ance policies, paid by reason of the death of an insured to his estate or to a beneficiary (individual, partnership, or corporation) directly or in trust, are excluded from the gross income of the beneficiary, except in the case of certain transferees as provided in § 39.22 (b) (2)-3 and in the case of a spouse to whom such payments are income under section 22 (k) It is immaterial whether the proceeds are received in a single sum or otherwise. If, however, such proceeds are held by the insurer under an agreement to pay interest thereon, the interest payments must be included in gross income.

§ 39.22 (b) (1)-2 *Death payment by employer· amounts paid by reason of the death of an employee.* (a) (1) Amounts, not in excess of $5,000, paid by an employer in pursuance of an express contract to the estate or to a beneficiary (individual, partnership, trust, or corporation) of an employee, including a former employee, by reason of the employee's death shall be excluded from the gross income of such beneficiary. Where such death payments are made by more than one employer, including former employers of the decedent, a $5,000 exclusion applies separately to amounts receivable from each employer or former employer of the decedent. Where the aggregate payments by an employer, under an express contract, to the beneficiaries of the deceased employee exceed $5,000, the $5,000 exclusion shall be proportioned among the beneficiaries in the same proportion as the amount payable to or received by each under such contract bears to the total death payment the employer is contractually obligated to make. It is immaterial whether the proceeds are received in a single sum or otherwise. If, however, the proceeds are held by an employer under an agreement to pay interest thereon, the interest payment must be included in gross income.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). The M Corporation, the employer of A, who died on November 30, 1952, was liable under an express contract to pay a death payment of $15,000 to the beneficiaries of A, to be distributed as follows: $5,000 to the widow of A; $2,500 each to the parents of A; and $1,000 each to the five children of A. Each of the beneficiaries of A, except his widow, received such payment in a lump sum in January 1953. The widow of A elected to receive her share of the death payment in monthly installments of $100 beginning with the month of January 1953. All of the beneficiaries filed income tax returns on a calendar year basis. Apportioning the $5,000 exclusion in the same proportions as the total death payments the employer is contractually obligated to make, the widow of A shall exclude $1,666.67 of the monthly payments made to her (one-third of $5,000); each of A's parents shall exclude $833.33 of his or her death payment (one-sixth of $5,000)· and each of the five children shall exclude $333.33 (one-fifteenth of $5,000. In the case of the widow, $1,200 of her monthly payments shall be excluded from her income tax return for the year 1953 and the balance of $466.67 from her return for the year 1954.

Example (2). H died on July 1, 1953. At the time of his death he was employed by the A Corporation, which was liable under an express contract to pay a death payment of $2,500 to W, his widow. The B Corporation, a former employer of H, was also liable under an express contract to pay a death payment of $5,000 to W. The $7,500 receivable by W from the A and B Corporations is excludable from her gross income.

(b) Where a payment is made on account of the death of an employee by a welfare fund or a trust, including a pension trust exempt under section 165 (a) in pursuance of an agreement entered into by an employer of the deceased employee, the payment shall be considered to have been made by the employer for the purpose of this section. Any part of death payment which is attributable to the contributions of the employee shall be disregarded in determining the amount paid by an employer.

(c) An express contract requiring payment by an employer to the beneficiaries of a deceased employee by reason of the latter's death shall be deemed to exist only if (1) the employer and employee had entered into a written contract, not revoked before the employee's death, which required such payment or (2) the employer had an established plan (or program having the effect of a plan) making provision for such payments in the case of his employees generally, or for a class or classes of his employees. In the latter case, the contract will be deemed to exist between the employer and the members of the class or classes of employees to whom the plan applies, provided such plan had been communicated to such employees and had not been rescinded before the death of the employee to whom the particular death payment relates. Communication of an employer's plan or program to his employees may be made in different ways, such as by publicizing or distributing to the employees concerned notice of the resolution approved by the board of directors which created the plan, or by distributing to the employees a booklet containing an explanation of the plan and the rights of their beneficiaries thereunder.

(d) (1) The exclusion from gross income provided by this section is limited solely to those amounts paid by or on behalf of an employer which, by the terms of the contract with the employee or by the provisions of the plan providing for such payments, are specifically designated and intended as a death payment, paid only by reason of the death of the employee. The exclusion does not apply to amounts with respect to which the deceased employee possessed, immediately prior to his death, a nonforfeitable right to receive the amounts while living. See § 39.165-7. Amounts to which the exclusion is not applicable include, among others, such items as uncollected salary, payments for unused leave, and amounts paid by or on behalf of an employer to the survivor of a deceased retired employee as a survivor's annuity, as to which see § 39.22 (b) (2)-2.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). A, who was a participant under the B Company pension plan, retired on December 31, 1951. He had made no contributions to the plan. Upon his retirement he became entitled to a monthly income of $100 payable for life, 120 months certain. A died in October 1952 having received 10 monthly payments of $100 each. His widow became entitled to 110 monthly payments representing the balance of the payments certain. No exclusion from gross income may be made by A's widow under this section since the employee's right to the monthly payments was nonforfeitable from the date of his retirement.

Example (2). The trustee of the C Corporation profit-sharing plan was required under the provisions of the plan to pay to the beneficiary of B, an employee of the C Corporation who died on July 1, 1952, the benefit due on account of the death of B. The provisions of the profit-sharing plan gave each participating employee in case of voluntary termination of employment a 10 percent vested interest in the amount accumulated in his account for each year of participation in the plan but, in case of death, the entire credit to the participant's account would be paid to his beneficiary. At the time of the death of B he had been a participant for three years and the accumulation in his account was $8,000. After his death this amount was paid to his beneficiary. At the time of the death of B the amount distributable to him on account of voluntary termination of employment was $2,400 (30 percent of $8,000). The difference of $5,600 ($8,000 minus $2,400), payable to the beneficiary of B only by reason of the death of B, is considered an amount payable solely by reason of B's death. Accordingly, $5,000 may be excluded from the gross income of the beneficiary receiving such payment.

Example (3). The X Corporation instituted a retirement plan for its employees, the cost thereof being borne entirely by the corporation. The plan provided, in part, as follows: If, after 10 years of service, an employee left the employ of the corporation, either voluntarily or involuntarily, before retirement, a percentage of the reserve provided for the employee in the pension trust fund would be paid the employee as follows: 10 to 15 years of service, 25 percent; 15 to 20 years of service, 50 percent; 20 to 25 years of service, 75 percent; 25 years of service or over, 100 percent. The plan further provided that if an employee died before reaching retirement age, his beneficiary would receive a percentage of the reserve provided for the employee in the retirement fund, on the same basis as shown in the preceding sentence. Y, an employee of the X Corporation for 17 years, died while in the employ of the corporation before retirement. His beneficiary received $7,500, an amount equal to 50 percent of the reserve provided for Y's retirement. No exclusion from gross income may be made by the beneficiary with respect to such payment since Y, prior to his death, had a nonforfeitable right to the payment.

§ 39.22 (b) (2) *Statutory provisions; exclusions from gross income; annuities, etc.*

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 chapter: * * *

(2) *Annuities, etc.*—(A) *In general.* 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 chapter 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. The preceding sentence shall not apply in the case of such a transfer if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor. This subparagraph and paragraph (1) shall not apply with respect to so much of a payment under a life insurance, endowment, or annuity contract, or any interest therein, as, under section 22 (k), is includible in gross income;

(B) *Employees' annuities.* If an annuity contract is purchased by an employer for an employee under a plan with respect to which the employer's contribution is deductible under section 23 (p) (1) (B), or if an annuity contract is purchased for an employee by an employer exempt under section 101 (6), the employee shall include in his income the amounts received under such contract for the year received except that if the employee paid any of the consideration for the annuity, the annuity shall be included in his income as provided in subparagraph (A) of this paragraph, the consideration for such annuity being considered the amount contributed by the employee. In all other cases, if the employee's rights under the contract are nonforfeitable except for failure to pay future premiums, the amount contributed by the employer for such annuity contract on or after such rights become nonforfeitable shall be included in the income of the employee in the year in which the amount is contributed, which amount together with any amounts contributed by the employee shall constitute the consideration paid for the annuity contract in determining the amount of the annuity required to be included in the income of the employee under subparagraph (A) of this paragraph.

(C) *Joint and survivor annuities.* For purposes of subparagraphs (A) and (B) of this paragraph, where amounts are received by a surviving annuitant under a joint and survivor's annuity contract and the basis of such survivor annuitant's interest is determined under section 113 (a) (5) the consideration paid for such survivor's annuity shall be considered to be an amount equal to such basis.

[Sec. 22 (b) (2) as amended by secs. 110 (a), 120 (d), 162 (c), Rev. Act 1942; sec. 303 (a), Rev. Act 1951]

§ 39.22 (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, amounts received as annuities, and amounts of periodic payments included in gross income under section 22 (k)) 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. For the purposes of this rule, the term "amounts received before the taxable year under such policy" shall not be construed to include so much of any payments as were included in gross income as amounts received as an annuity under an annuity or endowment contract for taxable years ending before but not on December 31, 1948. Appropriate adjustment will be required with respect to such payments, or portion thereof, so included as form the basis of a pending or successful claim or suit for refund. For definition of "annuity" see § 39.22 (b) (2)-2.

§ 39.22 (b) (2)-2 *Annuities.* (a) (1) As used in section 22 (b) (2) (A), "amounts received as an annuity under an annuity or endowment contract" means amounts (based on a computation with reference to life expectancy and mortality tables and payable over a period longer than one year) received in periodical installments, whether annually, semiannually quarterly, monthly, or otherwise. For adjustment in the case of amounts received in periodical installments for a fixed period and included in gross income for taxable years ending before but not on December 31, 1948, as an annuity under an annuity or endowment contract, see § 39.22 (b) (2)-1. Such portion of each installment payment of an annuity (where the whole payment is not required to be included in income under section 22 (k)) 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. Annuities paid to retired employees pursuant to the Civil Service Retirement Act of May 29, 1930, as amended (5 U. S. C., c. 14) are subject to section 22 (b) (2), the aggregate premiums or consideration paid for such annuities being the total of the amounts previously withheld from the compensation of the employees.

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

Example (1). A bought in 1949, for $50,000 consideration, a life annuity, payable in annual installments of $5,000. For the calendar year 1952, 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 exempt amounts totaling $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, 1952, 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, 1952, 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 1952 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, 1952, 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, 1952, amounting to $250. A shall include in his gross income for the calendar year 1952 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).

(b) (1) If, in the case of amounts received under a joint and survivor's annuity, the value of any part of the survivor's interest is required to be included in the gross estate of a decedent annuitant dying after December 31, 1950, under the provisions of section 811 (whether or not such estate exceeds $60,000 so as to require the filing of an estate-tax return under section 937, the basis of such interest to the survivor annuitant is considered to be the value of the life annuity to the survivor at the time of the decedent's death as determined under section 113 (a) (5) Such valuation shall be substituted, effective upon the date of death of the first annuitant, in lieu of the consideration previously used, if any, for purposes of determining the taxable amounts of the annuity payments received after such date of death. Likewise, the amount of consideration determined in accordance with this rule shall, with respect to survivor annuity payments made after the death of the first annuitant, be substituted for the amount of consideration, if any, that may be recovered without inclusion in gross income.

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

Example (1). H and W on August 1, 1947, each contributed $30,000 toward the purchase of a joint and survivor's annuity of $12,000 a year, payable in monthly installments. On August 15, 1952, H died. There is includible in his estate under the provisions of section 811 the amount of $30,000 attributable to the decedant's interest in the annuity contract. The value of the annuity payments to be received by W subsequent to H's death (i. e., the cost of providing an annuity of $12,000 a year during the remaining life of W) is determined, under the provisions of section 113 (a) (5), to be $60,000. This amount is deemed to be the consideration paid by W, effective August 15, 1952, for the annuity payments to be received by her subsequent to that date. Therefore, of the monthly payments made to W following H's death, W shall include the sum of $150, being such portion of the installment as is not in excess of 3 percent of $60,000 (the consideration deemed to have been paid) divided by

12. The full amount of the annuity will not become includible in gross income until $60,000 shall have been recovered.

Example (2). H, an employee of the M Corporation, retired on January 1, 1952. Under the company's retirement plan H was entitled, upon retirement, to elect to receive a life annuity of $2,400 annually or a reduced annuity with a provision that his wife would receive $1,200 annually during her lifetime if he should predecease her. The M Corporation inaugurated its retirement plan in 1949 and paid the entire cost of all annuities. H elected to take the reduced annuity. He died on November 1, 1952, and thereafter his wife W received $1,200 annually in equal monthly installments. By reason of H's election to accept a reduced annuity with survivor payments for his widow, there is includible in his estate under the provisions of section 811 the amount of $12,000. This is the same valuation, as determined under section 113 (a) (5), placed on the annuity payments receivable by W subsequent to H's death. Therefore, W shall include in her gross income with respect to each monthly annuity payment received subsequent to November 1, 1952, the sum of $30, being such portion of the installment as is not in excess of 3 percent of $12,000 (the consideration deemed to have been paid) divided by 12. The full amount of the annuity payments will not become includible in gross income until $12,000 of the annuity payments received after H's death shall have been excluded from income. It is immaterial that H had no cost basis with respect to his annuity and had to include the full amount thereof in his gross income.

§ 39.22 (b) (2)-3 *Transfers of life insurance, endowment, or annuity contracts.* (a) 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, to which section 22 (b) (1) or (2) (A) applies, only the actual value of the consideration given for such transfer and the amount of the premiums and other sums subsequently paid by the transferee shall be excluded from gross income, in lieu of the amounts provided in §§ 39.22 (b) (1)-1, 39.22 (b) (2)-1, or 39.22 (b) (2)-2 to be excluded with respect to payments under such life insurance, endowment, or annuity contract. In the event of such a transfer (other than to the insured) the rule stated in the preceding sentence transforms the exemption applicable under section 22 (b) (1) or (2) (A) from that determined as in the case of the insured or person to whom the policy was originally issued to an exemption determined as in the case of a transferee for a valuable consideration. The exemption applicable in the case of a transferee without valuable consideration or a donee beneficiary is determined in accordance with the rule applicable in the case of its last transferor or last owner of the policy. For the purpose of determining gross income in the case of a transfer of a life insurance, endowment, or annuity contract or any interest therein, if such contract or interest therein has a basis for determining gain or loss in the hands of the transferee determined, in whole or in part, by reference to such basis of such contract or interest therein in the hands of the transferor, the rule stated in the first sentence of this section shall not apply as to such transfer, and the rule applicable under section 22 (b) (1) or (2) (A) to a transferee without valuable consideration (as stated in the preceding sentence) shall apply as if the transfer from such transferor to such transferee were without valuable consideration. Thus, where a corporation acquires a life insurance policy from a predecessor corporation in a tax-free reorganization, if the proceeds received under the policy by reason of the death of the insured would be exempt from taxation in the hands of the transferor, such proceeds received by reason of the death of the insured will be exempt from taxation in the hands of the transferee, because the basis is determined with reference to the basis in the hands of the transferor.

(b) The following examples illustrate the application of the provisions of paragraph (a)

Example (1). The A Corporation procures, for a single premium of $500, an insurance policy in the face amount of $1,000 upon the life of X, one of its officers, naming the A Corporation as beneficiary. If X dies during the time the policy is held by the corporation, the proceeds of the policy paid by reason of the death of X will be tax-free to the corporation. If the A Corporation transfers the policy to the B Corporation for a valuable consideration (for example, $600 in cash, and not pursuant to a tax-free exchange or reorganization), the proceeds paid to the B Corporation by reason of the death of X would be taxable to the extent of $400 ($1,000 minus $600). Similarly, if, before the death of X, the B Corporation had transferred the policy to the C Corporation in a tax-free reorganization, the proceeds in the hands of the C Corporation would be taxable to the extent of $400, since $600, the consideration paid by Corporation B for the transfer, would be exempt.

Example (2). In 1932, Y took out an annual premium 20-year endowment policy having a maturity value of $20,000. After payment of premiums totaling $5,500, Y assigned the policy to the M Corporation for a consideration of $4,000. If the M Corporation held the policy and paid the premiums thereon, the $20,000 received upon maturity of the policy (while A is still alive) would be includible in the income of the M Corporation, except to the extent of the $4,000 consideration paid by it and the premiums which it paid after the transfer. If, prior to the maturity of the policy, the M Corporation transferred its assets, including the policy, to the N Corporation in a tax-free exchange for the stock of the N Corporation and the N Corporation held the policy until maturity (1952), paying all premiums due thereon after such transfer, the $20,000 received by the N Corporation would be includible in its gross income, except to the extent of the $4,000 consideration paid by the M Corporation for the transfer of the policy from Y and the aggregate premiums paid by the M and N Corporations upon the policy.

§ 39.22 (b) (2)-4 *Annuity, etc., payments in discharge of alimony obligation.* The full amount of any periodic payment received under a life insurance, endowment, or annuity contract by a spouse or former spouse is required to be included in her gross income if certain conditions specified in section 22 (k) exist. See § 39.22 (k)-1. Paragraphs 1 and 2 (A) of section 22 (b) do not apply (except the last sentence of section 22 (b) (2) (A)) with respect to so much of a payment as under section 22 (k) is includible in gross income. For example, upon the divorce of a husband and wife, the decree may require the husband to provide the wife with an annuity of $2,000 for her life. The wife, being desirous of a greater assured income, may pay with the husband to an insurance company a consideration which, when added to the amount paid by the husband, purchases an annuity paying $3,000. For each taxable year, $2,000 is to be included in her income under section 22 (k) and such portion of $1,000 is to be included in her income as is required under § 39.22 (b) (2)-2 on the basis of the consideration paid by her to the company.

§ 39.22 (b) (2)-5 *Employees' annuities.* (a) If an employer purchases an annuity contract on behalf of an employee, including a retired or former employee, under a plan with respect to which his contribution is deductible under section 23 (p) (1) (B) (see § 39.23 (p)-9) the employee is not required to include such amount in his income in the taxable year during which such contribution is made. The amount received or made available to such employee under such annuity contract shall be included in gross income of the employee in the taxable year in which received or made available, except that if the employee contributed any of the consideration for the annuity, the annuity shall be included in his income as provided in § 39.22 (b) (2)-2, the consideration for the annuity being considered the amount contributed by the employee. Except as provided in section 165 (d), if an employer purchases an annuity contract which is not under a plan with respect to which his contribution is deductible under section 23 (p) (1) (B), the amount of such contribution shall be included in the income of the employee in the taxable year during which such contribution is made, if the employee's rights under the annuity contract are nonforfeitable, except for failure to pay future premiums; at the time the contribution is made. In such case, the total amount of such contributions required to be included in the income of the employee together with any amounts contributed by him will constitute the consideration paid for the annuity contract in determining the amount of the annuity required to be included in the income of the employee under section 22 (b) (2) (A) If the employee's rights under the annuity contract in such a case were forfeitable at the time the employer's contribution was made for the annuity contract, even though they become nonforfeitable later, the amount of such contribution is not required to be included in the income of the employee, but any amount received or made available to the employee under the annuity contract shall be includible in the gross income of the employee in the taxable year in which received or made available, except that if the employee contributed any of the consideration for the annuity, the annuity shall be included in his income to the extent provided in § 39.22 (b) (2)-2. The fact that an employee may not live a sufficient length of time to enjoy any benefits under the annuity contract, or that no payments will be

made under any circumstances to his estate or other beneficiary, will not make the annuity contract forfeitable.

(b) If an employer has purchased annuity contracts and transferred the same to a trust or if an employer has made contributions to a trust for the purpose of providing annuity contracts for his employees as provided in section 165 (d) (see § 39.165-7) the amount so paid or contributed is not required to be included in the income of the employee, but any amount received or made available to the employee under the annuity contract shall be includible in the gross income of the employee in the taxable year in which received or made available. In such case the amount paid or contributed by the employer shall not constitute consideration paid by the employee for such annuity contract in determining the amount of annuity payments required to be included in his gross income under section 22 (b) (2) unless the employee has paid income tax for any taxable year beginning prior to January 1, 1949, with respect to such payment or contribution by the employer for such year and such tax is not credited or refunded to the employee. In the event such tax has been paid and not credited or refunded the amount paid or contributed by the employer for such year shall constitute consideration paid by the employee for the annuity contract in determining the amount of the annuity required to be included in the income of the employee under section 22 (b) (2) (A) For example, an employer in 1945 purchased and transferred to a trust meeting the requirements of section 165 (d) a life annuity contract (payable in annual installments of $5,000) for an employee at a cost to the employer of $50,000. If the employee included the $50,000 in his gross income for 1945 and paid a tax with respect thereto and if it be assumed that such year is closed so that the amount so paid cannot be credited or refunded, only $1,500 of each $5,000 yearly annuity payment to the employee will be required to be included in his gross income (3 percent of $50,000) $3,500 being exempt. If the employee should live long enough to receive exempt amounts totaling $50,000, then all amounts he receives thereafter under the annuity contract would be included in gross income. If, in the foregoing case, the employee's taxable year 1945 was not closed and the employee secured a refund or credit of the tax previously paid with respect to the $50,000 premium payment made by his employer, then all amounts received under the annuity contract will be required to be included in his gross income.

(c) Except as provided in § 39.22 (b) (2)-2 with respect to joint and survivor annuity payments received subsequent to the death of an annuitant who died after December 31, 1950, if upon the death of a retired employee, the widow or other beneficiary of such retired employee is paid, in accordance with the terms of the annuity contract relating to the deceased employee, an annuity or other death benefit, the amounts received by or made available to her shall be included in her income to the extent that they would have been included in the income of the deceased employee had he lived and received such payments. See also section 126 (a) As to taxation of life insurance benefits in connection with annuity contracts, see § 39.165-6.

(d) If the employer is an organization which is exempt under section 101 (6), the employee is not required to include in his income the amount paid by the employer for an annuity contract, regardless of whether the annuity plan satisfies the requirements of section 165 (a) (3) (4) (5) and (6) and whether the employee's rights are nonforfeitable.

(e) As to taxation of annuities purchased by a trustee under a pension or profit-sharing trust, see §§ 39.165-6 and 39.165-7.

(f) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 3797 (a) (20).

§ 39.22 (b) (3) *Statutory provisions; exclusions from gross income; gifts, bequests, devises, and inheritances.*

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 chapter: * * *

(3) *Gifts, bequests, devises, and inheritances.* The value of property acquired by gift, bequest, devise, or inheritance. There shall not be excluded from gross income under this paragraph, the income from such property, or, in case the gift, bequest, devise, or inheritance is of income from property, the amount of such income. For the purposes of this paragraph, if, under the terms of the gift, bequest, devise, or inheritance, payment, crediting, or distribution thereof is to be made at intervals, to the extent that it is paid or credited or to be distributed out of income from property, it shall be considered a gift, bequest, devise, or inheritance of income from property;

[Sec. 22 (b) (3) as amended by sec. 111 (a), Rev. Act 1942]

§ 39.22 (b) (3)-1 *Gifts and bequests.* (a) Property received as a gift, or received under a will or under statutes of descent and distribution, is not includible in gross income, although the income from such property is includible in gross income. If the gift, bequest, devise, or inheritance is of income from property, it is not to be excluded from gross income. An amount of principal paid under a marriage settlement is a gift. As to alimony or an allowance paid upon divorce or legal separation, see § 39.22 (k)-1.

(b) Section 22 (b) (3) provides a special rule for the treatment of gifts, bequests, devises, or inheritances which by their terms are to be paid, credited, or to be distributed at intervals. To the extent any such gift, bequest, devise, or inheritance is paid, credited, or to be distributed out of income from property, it shall be considered a gift, bequest, devise, or inheritance of income from property. Section 22 (b) (3) is designed to provide the same treatment for amounts of income from property, which income is paid, credited, or to be distributed under a gift or bequest, whether the gift or bequest is in terms of a right to payments at intervals (regardless of income) or is in terms of a right to income. To the extent the amounts in either case are paid, credited, or to be distributed at intervals out of income they are not to be excluded under section 22 (b) (3) from the taxpayer's gross income. As to the extent such amounts are paid, credited, or to be distributed out of income from property in cases in which the payment, crediting, or distribution thereof is to be made by an estate or trust, see section 162 and the regulations thereunder.

(c) The operation of the last sentence of section 22 (b) (3) may be illustrated by the following example:

Example. A, by his will, gave his wife an annuity of $50,000 to be paid in advance in quarterly payments. By another clause of his will, A bequeathed the residue of his property in trust with directions to the trustees to collect the income from the property and to pay the annuity of $50,000 out of such income (after payment of expenses), or out of corpus to the extent such income is insufficient. Under the provisions of section 22 (b) (3), the $50,000 will be included in the wife's income each year and, under the provisions of section 162 (b), will be deducted from the income of the trust to the extent of the income of the trust for its taxable year which is considered under section 162 (d) to be distributed in satisfaction of the annuity.

(d) The last sentence of section 22 (b) (3), however, applies only to such amounts as are to be paid or credited at intervals. Thus, a bequest of money or property (other than income) intended to be paid in a lump sum or at one time is not to be included in the legatee's gross income, even though the executor may for reasons of convenience or necessity arrange to pay such amount in installments or pay it out of funds traceable as the income of property. However, payments at intervals do not need to be at regular intervals to come within the rule stated in the last sentence of section 22 (b) (3). Thus, in case of a direction in a testamentary trust to pay $5,000 a year to John for his life but to pay the $5,000 a year to Mary instead of John for any year in which Mary becomes 18, graduates from college, or marries, the $5,000 a year is income to John and Mary, respectively, in the years in which each is to receive it, to the extent it is paid or credited in such years out of income from the trust property.

(e) Section 22 (b) (3) is not intended to tax a donee upon the same income which is taxed to the grantor of a trust or assignor of earnings or other income under section 22 (a), section 166, or section 167.

§ 39.22 (b) (4) *Statutory provisions; exclusions from gross income; tax-free interest.*

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 chapter: * * *

(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 corpora-

tion 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, when so required by regulations prescribed by the Commissioner, with the approval of the Secretary, submit in the return required by this chapter 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 such regulations may prescribe. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit to the extent they represent deposits made before March 1, 1941) 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 chapter;

[Sec. 22 (b) (4) as amended by sec. 112 (a), Rev. Act 1942; sec. 11 (d), Individual Income Tax Act 1944]

SEC. 4. [Public Debt Act of 1941.]

(a) Interest upon, and gain from the sale or other disposition of, obligations issued on or after the effective date of this Act by the United States or any agency or instrumentality thereof shall not have any exemption, as such, and loss from the sale or other disposition of such obligations shall not have any special treatment, as such, under Federal tax Acts now or hereafter enacted; except that any such obligations which the United States Maritime Commission or the Federal Housing Administration has, prior to the effective date of this Act, contracted to issue at a future date, shall when issued bear such tax-exemption privileges as were, at the time of such contract, provided in the law authorizing their issuance. For the purposes of this subsection a Territory, a possession of the United States, and the District of Columbia, and any political subdivision thereof, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States.

(b) The provisions of this section shall, with respect to such obligations, be considered as amendatory of and supplementary to the respective Acts or parts of Acts authorizing the issuance of such obligations, as amended and supplemented.

SEC. 5. This Act, except sections 2 (b) and (c), shall become effective on the first day of the month following the date of its enactment [February 19, 1941].

SEC. 6. [PUBLIC DEBT ACT OF 1942.]

Section 4 of the Public Debt Act of 1941 is hereby amended to read as follows:

"Sec. 4 (a) Interest upon obligations, and dividends, earnings, or other income from shares, certificates, stock, or other evidences of ownership, and gain from the sale or other disposition of such obligations and evidences of ownership issued on or after the effective date of the Public Debt Act of 1942 [March 28, 1942] by the United States or any agency or instrumentality thereof shall not have any exemption, as such, and loss from the sale or other disposition of such obligations or evidences of ownership shall not have any special treatment, as such, under Federal tax Acts now or hereafter enacted; except that any such obligations which the United States Maritime Commission or the Federal Housing Administration had, prior to March 1, 1941, contracted to issue at a future date, shall when issued bear such tax-exemption privileges as were, at the time of such contract, provided in the law authorizing their issuance. For the purposes of this subsection a Territory, a possession of the United States, and the District of Columbia, and any political subdivision thereof, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States. * * *"

SEC. 11. [Organic Act of Guam, 1950.]

* * * All bonds issued by the government of Guam or by its authority shall be exempt, as to principal and interest, from taxation by the Government of the United States or by the government of Guam, or by any State or Territory or any political subdivision thereof, or by the District of Columbia.

SEC. 3. [Puerto Rican Federal Relations Act.]

* * * and all bonds issued by the Government of Puerto Rico, or by its authority, shall be exempt from taxation by the Government of the United States, or by the Government of Puerto Rico or of any political or municipal subdivision thereof, or by any State, Territory, or possession, or by any county, municipality, or other municipal subdivision of any State, Territory, or possession of the United States, or by the District of Columbia. * * *

[Sec. 3 as amended by sec. 2, Pub. Law 301 (64th Cong.); Pub. Law 391 (75th Cong.).]

SEC. 1. [Pub. Law 418 (81st Cong.).] * * * All bonds issued by the government of the Virgin Islands or any municipality thereof, including specifically interest thereon, shall be exempt from taxation by the Government of the United States, or by the government of the Virgin Islands or any political subdivision thereof, or by any State, Territory, or possession or by any political subdivision of any State, Territory, or possession, or by the District of Columbia: * * *

§ 39.22 (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. 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.

§ 39.22 (b) (4)-2 *Dividends from shares and stock of Federal agencies or instrumentalities*—(a) *Issued before March 28, 1942.* (1) Section 26 of the Federal Farm Loan Act of July 17, 1916 (12 U. S. C. 931) provides that Federal land 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. Section 7 of the Federal Reserve Act of December 23, 1913 (12 U. S. C. 531), 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. Section 13 of the Federal Home Loan Bank Act (12 U. S. C. 1433) provides that the Federal Home Loan Bank including its franchise, its capital, reserves, and surplus, its advances, and its income shall be exempt from all taxation, except taxes upon real estate. Section 5 (h) of the Home Owners' Loan Act of 1933 (12 U. S. C. 1464 (h)) provides that shares of Federal savings and loan associations shall, both as to their value and the income therefrom, be exempt from all taxation (except surtaxes, estate, inheritance, and gift taxes) imposed by the United States. Under the above-mentioned provisions, income consisting of dividends on stock of Federal land banks, national farm-loan associations, Federal home loan banks, and Federal reserve banks is not, in the case of stock issued before March 28, 1942, subject to the income tax; and income consisting of dividends on share accounts of Federal savings and loan associations is not, in the case of shares issued before March 28, 1942, subject to the normal tax on income. For taxability of such income in the case of such stock or shares issued on or after March 28, 1942, see section 6 of the Public Debt Act of 1942 (31 U. S. C. 742a) and paragraph (b) of this section. For the time at which a stock or share is issued within the meaning of this section, see paragraph (b) of this section.

(2) Regardless of the exemption from income tax of dividends paid on the stock of Federal reserve banks, dividends paid by member banks are treated like dividends of ordinary corporations.

(3) 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 the normal tax and surtax (see section 63 of the Farm Credit Act of 1933 (12 U. S. C. 1138c))

(b) *Issued on or after March 28, 1942.* (1) By virtue of the provisions of section 6 of the Public Debt Act of 1942, the tax exemption provisions set forth in paragraph (a) of this section with respect to income consisting of dividends on stock of the Federal land banks, national farm-loan associations, and Federal reserve banks, or on share accounts of Federal savings and loan associations, are not applicable in the case of dividends on such stock or shares issued on or after March 28, 1942.

(2) For the purposes of this section, a stock or share is deemed to be issued at the time and to the extent that payment therefor is made to the agency or instrumentality. The date of issuance of the certificate or other evidence of ownership of such stock or share is not determinative if payment is made at an earlier or later date. Where old stock is retired in exchange for new stock of

a different character or preference, the new stock shall be deemed to have been issued at the time of the exchange rather than when the old stock was paid for. These rules may be illustrated by the following examples:

Example (1). A, the owner of an investment share account, consisting of 10 shares, in a Federal savings and loan association, has a single certificate issued before March 28, 1942, evidencing such ownership. In order that A may dispose of half of such shares, the association at his request issues, after March 27, 1942, two 5-share certificates in substitution for the 10-share certificate. The shares evidenced by the two new certificates are deemed to have been issued before March 28, 1942, the shares having been paid for before such date.

Example (2). The X Bank, a member of a Federal reserve bank, owns 50 shares of Federal reserve bank stock, evidenced by a single stock certificate issued before March 28, 1942. On December 31, 1942, the X Bank reduces the amount of its capital stock, as a result of which it is required to reduce the amount of its Federal reserve bank stock to 40 shares. It surrenders the 50-share certificate to the Federal reserve bank and receives a new 40-share certificate. The 40 shares evidenced by such certificate are deemed to have been issued before March 28, 1942. On December 31, 1943, the X Bank increases the amount of its capital stock, as a result of which it is required to purchase 10 additional shares of the Federal reserve bank stock. The Federal reserve bank issues a 10-share certificate evidencing ownership of the new shares. Of the 50 shares then owned by the X Bank, 40 were issued prior to March 28, 1942, and 10 were issued after March 27, 1942.

Example (3). A, the owner of a savings share account, in the amount of $100, in a Federal savings and loan association, has a passbook containing a certificate issued prior to March 28, 1942, evidencing such ownership. Subsequent to March 27, 1942, A deposits $10,000 in the account. With respect to the $10,000 deposit, the share is deemed to have been issued after March 27, 1942.

§ 39.22 (b) (4)-3 *Interest upon notes secured by mortgages executed to Federal agencies or instrumentalities.* Section 26 of the Federal Farm Loan Act of July 17, 1916 (12 U. S. C. 931) and section 210 of such act, as added by section 2 of the act of March 4, 1923 (12 U. S. C. 1111) provide that first mortgages executed to Federal land banks, joint-stock land banks, or Federal intermediate credit banks, and the income derived therefrom, shall be exempt from taxation. Accordingly, income consisting of interest on promissory notes held by such banks and secured by such first mortgages is not subject to the income tax.

§ 39.22 (b) (4)-4 *Interest upon United States obligations*—(a) *Issued before March 1, 1941.* (1) 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.

(2) 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 § 39.23 (e)-1.

(3) Interest on Treasury bonds is exempt from Federal income taxes except surtaxes imposed upon the income or profits of individuals, associations, or corporations. However, interest on an aggregate of not exceeding $5,000 principal amount of such bonds is also exempt from surtaxes. Interest in excess of the interest on an aggregate of not exceeding $5,000 principal amount of such bonds is subject to surtax and must be included in gross income.

(4) Section 26 of the Federal Farm Loan Act of July 17, 1916 (12 U. S. C. 931) and section 210 of such act, as added by section 2 of the act of March 4, 1923 (12 U. S. C. 1111), provide that farm-loan bonds issued by Federal land banks and joint-stock land banks and debentures issued by Federal intermediate credit banks, with the income therefrom, shall be exempt from taxation. Accordingly, interest from such farm-loan bonds or debentures is not subject to the income tax.

(5) Interest credited to postal savings accounts upon moneys deposited before March 1, 1941, in postal savings banks is wholly exempt from income tax.

(b) *Issued on or after March 1, 1941.* (1) By virtue of the provisions of sections 4 and 5 of the Public Debt Act of 1941, the exemption prescribed in paragraph (a) of this section is limited to such bonds, debentures, notes, or certificates of indebtedness as have been issued before March 1, 1941. Under such provisions interest upon obligations issued on or after March 1, 1941, by the United States, or any agency or instrumentality thereof, shall not have any exemption, as such, from Federal tax except in respect of any such obligations which the United States Maritime Commission or the Federal Housing Administration has, before March 1, 1941, contracted to issue at a future date. The interest on such obligations so contracted to be issued shall bear such tax-exemption privileges as were at the time of such contract provided in the law authorizing their issuance. For the purposes hereof, under section 4 (a) of the Public Debt Act of 1941, a Territory, a possession of the United States, and the District of Columbia and any political subdivisions thereof, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States.

(2) In the case of obligations issued as the result of a refunding operation, as, for example, where a corporation exchanges bonds for previously issued bonds, the refunding obligations are deemed, for the purposes of this section, to have been issued at the time of the exchange rather than at the time the original bonds were issued.

§ 39.22 (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.

§ 39.22 (b) (4)-6 *Interest upon United States obligations in the case of nonresident aliens and foreign corporations, not engaged in business in the United States.* By virtue of section 4 of the Victory Liberty Loan Act of March 3, 1919 (31 U. S. C. 750) amending section 3 of the Fourth Liberty Bond Act of July 9, 1918 (31 U. S. C. 750) 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, if such individual, corporation, partnership, or association is not engaged in business in the United States, is exempt from income taxes. Such exemption applies only to such bonds, notes, or certificates as have been issued before March 1, 1941. Interest derived by a nonresident alien individual, or by a foreign corporation, partnership, or association on such bonds, notes, or certificates issued on or after March 1, 1941, is subject to tax as in the case of taxpayers generally as provided in § 39.22 (b) (4)-4 (b).

§ 39.22 (b) (5) *Statutory provisions; exclusions from gross income; compensation for injuries or sickness.*

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 chapter: * * *

(5) *Compensation for injuries or sickness.* Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 23 (x) in any prior taxable year, 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, and amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country;

[Sec. 22 (b) (5) as amended by secs. 113, 127 (d), Rev. Act 1942]

SEC. 402. [Career Compensation Act of 1949.] * * *

(h). That part of the disability retirement pay computed on the basis of years of active service which is in excess of the disability retirement pay that a member would receive if such disability pay were computed on the basis of percentage of disability shall not be deemed to be a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country within the meaning of section 22 (b) (5) of the Internal Revenue Code, as amended. * * *

§ 39.22 (b) (6)–(9) *Statutory provisions; exclusions from gross income; ministers; income exempt under treaty; miscellaneous; income from discharge of indebtedness.*

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 chapter: * * *

(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.

(9) *Income from discharge of indebtedness.* In the case of a corporation, the amount of any income of the taxpayer attributable to the discharge, within the taxable year, of any indebtedness of the taxpayer or for which the taxpayer is liable evidenced by a security (as hereinafter in this paragraph defined) if the taxpayer, at such time and in such manner as the Secretary by regulations prescribes, makes and files its consent to the regulations prescribed under section 113 (b) (3) then in effect. In such case the amount of any income of the taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction. As used in this paragraph the term "security" means any bond, debenture, note, or certificate, or other evidence of indebtedness, issued by any corporation.

[Sec. 22 (b) (9) as added by sec. 215 (a), Rev. Act 1939; amended by sec. 114 (a), Rev. Act 1942; sec. 152, Rev. Act 1945; sec. 1, Pub. Law 578 (79th Cong.); sec. 3, Pub. Law 112 (80th Cong.); sec. 3, Pub. Law 271 (81st Cong.); sec. 201, Rev. Act 1950; sec. 304 (a), Rev. Act 1951]

§ 39.22 (b) (9)–1 *Income from discharge of indebtedness.* (a) Section 22 (b) (9) provides a method whereby a corporation may elect to have excluded from its gross income the amount of the income attributable to a discharge, within the taxable year, of its indebtedness or of indebtedness for which it is liable as, for example, in the case of a debt arising from an assumption of liability of another corporation. To be entitled to the benefits of section 22 (b) (9) a corporation must file with its return for the taxable year a consent to the provisions of the regulations, in effect at the time of the filing of the return, prescribed under section 113 (b) (3) (see §§ 39.113 (b) (3)–1 and 39.113 (b) (3)–2, relating to adjustment of basis) except that the consent may be filed with an amended return or claim for credit or refund, where the taxpayer establishes to the satisfaction of the Commissioner reasonable cause for failure to file the consent with its original return.

(b) As used in this section, the term "indebtedness" means indebtedness evidenced by a security, that is, by a bond, debenture, note, or certificate, or other evidence of indebtedness issued by either the taxpayer corporation or any other corporation regardless of when issued.

(c) If as a result of the discharge of indebtedness there remains unamortized premium or unamortized discount, the amount of the income attributable to such premium is to be excluded from gross income and the amount of the deduction attributable to such discount shall be disallowed as a deduction. The unamortized premium and unamortized discount, as the case may be, is in each instance to be computed as of the first day of the taxable year in which the discharge of indebtedness occurred.

(d) Section 22 (b) (9) and this section are inapplicable in the case of any discharge occurring in any proceeding under Chapter X or XI of the Bankruptcy Act (11 U. S. C., c. 10, 11) if the proceeding under such chapter was initiated by a petition filed on or before July 31, 1940, and with respect to any discharge of indebtedness to which section 22 (b) (10) applies.

§ 39.22 (b) (9)–2 *Making and filing of consent.* A consent to have the basis of its property adjusted in accordance with the provisions of the regulations, in effect at the time of filing of the return, prescribed under section 113 (b) (3) (see §§ 39.113 (b) (3)–1 and 39.113 (b) (3)–2) shall be made by or on behalf of the taxpayer corporation in duplicate on Form 982, in accordance with these regulations and the instructions on the form or issued therewith. The original and duplicate shall be filed with the return. In a case where a consent is permitted (under § 39.22 (b) (9)–1) after the original return has been filed, the original and duplicate of Form 982 shall be filed with the amended return or claim for credit or refund, as the case may be, and the consent shall be to the regulations which, at the time of the filing of the consent, are applicable to the taxable year for which such consent is filed.

§ 39.22 (b) (10) *Statutory provisions; exclusions from gross income; income from discharge of indebtedness of a railroad corporation.*

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 chapter: * * *

(10) *Income from discharge of indebtedness of a railroad corporation.* The amount of any income attributable to the discharge, within the taxable year, of any indebtedness of a railroad corporation, as defined in section 77m of the National Bankruptcy Act, as amended, to the extent that such income is deemed to have been realized by reason of a modification in or cancellation in whole or in part of such indebtedness pursuant to an order of a court in a receivership proceeding or in a proceeding under section 77 of the National Bankruptcy Act, as amended. In such case the amount of any income of the taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction. Paragraph (9) shall not apply with respect to any discharge of indebtedness to which this paragraph applies. This paragraph shall not apply to any discharge occurring in a taxable year beginning after December 31, 1954.

[Sec. 22 (b) (10) as added by sec. 114 (b), Rev. Act 1942; amended by sec. 152, Rev. Act 1945; sec. 1, Pub. Law 578 (79th Cong.); sec. 3, Pub. Law 112 (80th Cong.); sec. 3, Pub. Law 271 (81st Cong.); sec. 201, Rev. Act 1950; sec. 304 (b), Rev. Act 1951]

§ 39.22 (b) (10)–1 *Income from discharge of indebtedness of railroad corporations.* (a) Under section 22 (b) (10) the amount of any income attributable to the discharge, within the taxable year, of any indebtedness of a railroad corporation as a result of an order of a court in a receivership proceeding, or in a railroad reorganization proceeding under section 77 of the Bankruptcy Act (11 U. S. C. 205) is, for taxable years beginning before January 1, 1955, excluded from the gross income of the railroad corporation. The section is applicable only in a case where income accrues to a taxpayer from the modification or cancellation of the corporate indebtedness (whether in whole or in part) pursuant to a court order.

(b) The railroad corporations to which this section and section 22 (b) (10) apply are those defined in section 77 (m) of the Bankruptcy Act (11 U. S. C. 205 (m)) namely, any common carrier by railroad engaged in the transportation of persons or property in interstate commerce, except a street, a suburban, or interurban electric railway which is not operated as a part of a general railroad system of transportation or which does not derive more than 50 percent of its operating revenues from the transportation of freight in standard steam railroad freight equipment.

(c) As used in section 22 (b) (10) and this section, the term "indebtedness" means an obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount.

(d) If, as a result of the discharge of indebtedness, there remains unamortized premium or unamortized discount, the amount of the income attributable to such premium is to be excluded from

gross income and the amount of the deduction attributable to such discount shall be disallowed as a deduction. The unamortized premium and unamortized discount, as the case may be, is in each instance to be computed as of the first day of the taxable year in which the discharge of indebtedness occurred.

(e) The provisions of section 22 (b) (10) and this section are applicable with respect to any discharge occurring in a taxable year beginning before January 1, 1955.

§ 39.22 (b) (11) *Statutory provisions; exclusions from gross income; improvements by lessee on lessor's property.*

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 chapter: * * *

(11) *Improvements by lessee on lessor's property.* Income, other than rent, derived by a lessor of real property upon the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.

[Sec. 22 (b) (11) as added by sec. 115 (a), Rev. Act 1942]

§ 39.22 (b) (11)-1 *Exclusion from gross income of lessor of real property of value of improvements erected by lessee.* (a) Income derived by a lessor of real property upon the termination, through forfeiture or otherwise, of the lease of such property and attributable to buildings erected or other improvements made by the lessee upon the leased property is excluded from gross income. However, where the facts disclose that such buildings or improvements represent in whole or in part a liquidation in kind of lease rentals, the exclusion from gross income shall not apply to the extent that such buildings or improvements represent such liquidation. The exclusion applies only with respect to the income realized by the lessor upon the termination of the lease and has no application to income, if any, in the form of rent, which may be derived by a lessor during the period of the lease and attributable to buildings erected or other improvements made by the lessee. It has no application to income which may be realized by the lessor upon the termination of the lease but not attributable to the value of such buildings or improvements. Neither does it apply to income derived by the lessor subsequent to the termination of the lease incident to the ownership of such buildings or improvements.

(b) The provisions of this section may be illustrated by the following example:

Example. The A Corporation leased in 1945 for a period of 50 years unimproved real property to the B Corporation under a lease providing that the B Corporation erect on the leased premises an office building costing $500,000, in addition to paying the A Corporation a lease rental of $10,000 per annum beginning on the date of completion of the improvements, the sum of $100,000 being placed in escrow for the payment of the rental. The building was completed on January 1, 1947. The lease provided that all improvements made by the lessee on the leased property would become the absolute property of the A Corporation on the termination of the lease by forfeiture or otherwise and that the lessor would become entitled on such termination to the remainder of the sum, if any, remaining in the escrow fund. The B Corporation forfeited its lease on January 1, 1952, when the improvements had a value of $100,000. Under the provisions of section 22 (b) (11), the $100,000 is excluded from gross income. The amount of $50,000 representing the remainder in the escrow fund is forfeited to the A Corporation and is included in the gross income of that taxpayer. As to the basis of the property in the hands of the A Corporation, see § 39.113 (c)-1.

§ 39.22 (b) (12) *Statutory provisions; exclusions from gross income; recovery of bad debts, prior taxes, and delinquency amounts.*

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 chapter: * * *

(12) *Recovery of bad debts, prior taxes, and delinquency amounts.* Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

(A) *Definition of bad debt.* The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(B) *Definition of prior tax.* The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(C) *Definition of delinquency amount.* The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(D) *Definition of recovery exclusion.* The term "recovery exclusion" with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

(E) *Special rules in case of section 102 tax and personal holding company tax.* In the application of subparagraphs (A), (B), (C), and (D) in determining the tax under section 102 or Subchapter A of Chapter 2, a recovery exclusion allowed for the purposes of Chapter 1 shall be allowed for the purpose of such section or subchapter whether or not the bad debt, prior tax, or delinquency amount resulted in a reduction of the section 102 tax or Subchapter A tax for the prior taxable year; and in the case of a bad debt, prior tax, or delinquency amount not allowable as a deduction or credit for the prior taxable year under Chapter 1 (except section 102) but allowable for the same taxable year under such section or subchapter a recovery exclusion shall be allowable for the purposes of such section or subchapter if such bad debt, prior tax, or delinquency amount did not result in a reduction of the tax under such section 102 or such Subchapter A. As used in this subparagraph references to Chapter 1, section 102, and Subchapter A in the case of taxable years not subject to the Internal Revenue Code, shall be held to be made to corresponding provisions of prior revenue Acts.

[Sec. 22 (b) (12) as added by sec. 116 (a), Rev. Act 1942]

§ 39.22 (b) (12)-1 *Recovery of certain items previously deducted*—(a) *In general.* Section 22 (b) (12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. See Dobson v. Commissioner, 320 U. S. 489. The term "recovery exclusion" as used in this section means accordingly an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 22 (b) (12)) and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

(1) *Section 22 (b) (12) items.* The term "section 22 (b) (12) items" as used in this section means those bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. If a bad debt was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 22 (b) (12) item. Bad debts, prior taxes, and delinquency amounts are defined in section 22 (b) (12) (A) (B), and (C) respectively. A typical example of a delinquency amount described in that section is interest upon delinquent taxes. A typical example of the other items not expressly referred to in section 22 (b) (12) but nevertheless subject to the rule of exclusion is a loss sustained upon the sale of stock and later recovered, in whole or in part, through an action against the party from whom such stock had been purchased.

(2) *Definition of "recovery."* Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 22 (b) (12) items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. Care should be taken in the case of bad debts which were treated as only partially worthless in prior years to distinguish between the item described in section 22 (b) (12), that is, the part of such debt which was deducted, and the part

not previously deducted, which is not a section 22 (b) (12) item and is considered the first part collected. The collection of the part not deducted is not considered a "recovery." Furthermore, the term "recovery" does not include the gain resulting from the receipt of an amount on account of a section 22 (b) (12) item which, together with previous such receipts, exceeds the deduction or credit previously allowed for such item. For instance, a $100 corporate bond purchased for $40 and later deducted as worthless is subsequently collected to the extent of $50. The $10 gain (excess of $50 collection over $40 cost) is not a recovery of a section 22 (b) (12) item. Such gain is in no case excluded from gross income under section 22 (b) (12) regardless of whether the $40 recovery is or is not excluded.

(3) *Treatment of debt deducted in more than one year by reason of partial worthlessness.* In the case of a bad debt deducted in part for two or more prior years, each such deduction of a part of the debt is considered a separate section 22 (b) (12) item. A recovery with respect to such debt is considered first a recovery of those items (or portions thereof) resutling from such debt, for which there are recovery exclusions. If there are recovery exclusions for two or more items resulting from the same bad debt, such items are considered recovered in the order of the taxable years for which they were deducted, beginning with the latest. The recovery exclusion for any such item is determined by considering the recovery exclusion with respect to the prior year for which such item was deducted as being first used to offset all other applicable recoveries in the year in which the bad debt is recovered.

(4) *Special provisions as to worthless bonds, etc., which are treated as capital losses.* Bad debts on account of certain worthless securities and certain nonbusiness bad debts are treated as losses from the sale or exchange of capital assets. See section 23 (k) The amounts of the deductions allowed for any year under section 117 (d) on account of such losses for such year are considered to be section 22 (b) (12) items. Any part of such losses which, under section 117 (d) is a deduction for a subsequent year through the capital loss carry-over (any later receipt of an amount with respect to such deducted loss is a recovery) is considered a section 22 (b) (12) item for the year in which such loss was sustained.

(b) *Computation of recovery exclusion*—(1) *Amount of recovery exclusion allowable for year of recovery.* For the year of any recovery the section 22 (b) (12) items which were deducted or credited for one prior year are considered as a group and the recovery thereon is considered separately from recoveries of any items which were deducted or credited for other years. This recovery is excluded from gross income to the extent of the recovery exclusion with respect to this group of items as (i) determined for the original year for which such items were deducted or credited (see subparagraph (2) of this paragraph) and (ii) reduced by the excludible recoveries in intervening years on account of all section 22 (b) (12) items for such original year. A taxpayer claiming a recovery exclusion shall submit, at the time the exclusion is claimed, the computation of the recovery exclusion claimed for the original year for which the items were deducted or credited, and computations showing the amount recovered in intervening years on account of the section 22 (b) (12) items deducted or credited for the original year.

(2) *Determination of recovery exclusion for original year for which items were deducted or credited.* (i) The recovery exclusion for the taxable year for which section 22 (b) (12) items were deducted or credited (that is, the "original taxable year") is the portion of the aggregate amount of such deductions and credits which could be disallowed without causing an increase in any tax of the taxpayer imposed under chapter 1 of the Internal Revenue Code (such as the normal tax and surtax) other than the tax imposed on corporations by section 102 for the improper accumulation of surplus, or in any tax imposed under corresponding provisions of prior revenue laws. For the purpose of such recovery exclusion, consideration must be given to the effect of net operating loss carry-overs and carry-backs or capital loss carry-overs.

(ii) This rule shall be applied by determining the recovery exclusion as the aggregate amount of the section 22 (b) (12) items for the original year for which such items were deducted or credited reduced by whichever of the following amounts is the greatest:

(*a*) The difference between (*1*) the income subject to normal tax (net income reduced by credits allowable for normal tax purposes) for such original year and (*2*) the income subject to normal tax computed without regard to the section 22 (b) (12) items for such original year.

(*b*) The difference between (*1*) the net income subject to surtax for such original year and (*2*) the net income subject to surtax computed without regard to section 22 (b) (12) items for such original year.

(*c*) For taxable years beginning after December 31, 1942, and before January 1, 1944, in the case of taxpayers other than corporations, the difference between (*1*) the income subject to victory tax (the victory tax net income reduced by the specific exemption) for such original year and (*2*) the income subject to victory tax computed without regard to the section 22 (b) (12) items for such original year. See sections 450 to 476, inclusive, Internal Revenue Code as applicable to such taxable year.

(*d*) In the case of a taxpayer subject to any income tax in lieu of normal tax or surtax or both (except the alternative tax on capital gains imposed by section 117 (c) which is disregarded) the difference between (*1*) the income subject to such tax for such original year and (*2*) the income subject to such tax computed without regard to the section 22 (b) (12) items for such original year. (Neither the amount determined under (*1*) nor the amount under (*2*) of (*a*), (*b*), (*c*) or (*d*) of this subdivision shall in any case be considered less than zero.) For this determination of the recovery exclusion, the aggregate of the section 22 (b) (12) items must be further decreased by the portion thereof which caused a reduction in tax in preceding or succeeding taxable years through any net operating loss carry-overs or carry-backs or capital loss carry-overs affected by such items. This decrease is the aggregate of the largest amount determined for each of such preceding and succeeding years under (*a*) (*b*), (*c*), and (*d*) of this subdivision, the computation of each carry-over or carry-back to the preceding or succeeding year being made under (*1*) of (*a*), (*b*), (*c*), and (*d*) of this subdivision with regard to the section 22 (b) (12) items for the original year and such computation being made under (*2*) of (*a*), (*b*) (*c*), and (*d*) of this subdivision without regard to such items. For the purposes of the preceding sentence, the computations under both (*1*) and (*2*) of (*a*) (*b*), (*c*) and (*d*) of this subdivision shall be made without regard to any section 22 (b) (12) items for such preceding or succeeding year and the carry-overs and carry-backs to such year shall be determined without regard to any section 22 (b) (12) items for years subsequent to the original year.

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

Example. A single individual, who has no dependents, has for 1952 $2,800 gross income, a depreciation deduction of $2,000, and a deduction of $900 for bad debts and of $700 for property taxes. His income and deductions for 1951 are set out below. His recovery exclusion on account of the section 22 (b) (12) items for 1952 (the debts and taxes) is $600, determined by reducing the $1,600 aggregate of the section 22 (b) (12) items by the $200 difference between the surtax net income for 1952 computed with and without regard to such aggregate, since this difference is greater than such difference between the incomes subject to normal tax, ascertained as follows:

	With deduction of sec. 22 (b) (12) items	Without deduction of sec. 22 (b) (12) items
Gross income	$2,800	$2,800
Less: Depreciation	2,000	2,000
Remainder	800	800
Less: Bad debts and taxes	1,600	....
Net income or (loss)	(800)	800
Exemption under sec. 25 (b) (1) (A)	600	600
Surtax net income	0	200
Interest on U. S. obligations exempt from normal tax	0	80
Net income subject to normal tax	0	120
Difference between surtax net incomes ($200-$0)	....	200
Difference between incomes subject to normal tax ($120-$0)	....	120

The taxpayer had no items which would cause section 122 (d) adjustments for 1952 or 1951. For 1951 he had $6,000 gross income and his only deduction was a net operating loss deduction of $800 based on his loss for 1952. There would be no net operating loss

deduction for 1951 if the carry-back to 1951 was computed without regard to the section 22 (b) (12) items for 1952. Accordingly, $800 of such items for 1952 resulted, by way of carry-back to 1951, in a reduction of tax for 1951, since net income subject to normal tax and surtax net income for 1951 were reduced to the extent of the carry-back (computed in the manner set forth in the table above). The $1,600 aggregate of the section 22 (b) (12) items for 1952 is further reduced by the $800 which caused the reduction in tax through the carry-back. Therefore, the recovery exclusion for the items for 1952 is $600, that is, the $1,600 aggregate of such items reduced by the $200 and by the $800. If in 1956 the taxpayer recovers $400 of the property taxes, all of the recovery is excluded from the income by reason of the recovery exclusion of $600 determined for the original year 1952. If in 1957 he recovers all the bad debt of $900, $200 is excluded from gross income. That is, the recovery exclusion of $600 determined for the original year 1952 is reduced by the $400 recovery in 1956 on account of the section 22 (b) (12) items deducted for such original year.

(c) *Provisions as to taxes imposed by section 102 and subchapter A of chapter 2.* Section 22 (b) (12) (E) provides special rules for determining the recovery exclusion in the case of the tax imposed on corporations by section 102 for the improper accumulation of surplus and the tax imposed on personal holding companies by subchapter A of chapter 2 of the Internal Revenue Code. Such taxpayers have, for the purposes of such taxes, the recovery exclusion described in the preceding paragraphs of this section. This recovery exclusion is used for the purposes of the taxes imposed by section 102 and subchapter A of chapter 2 regardless of what particular effect the section 22 (b) (12) items had on such taxes, that is, regardless of whether the section 22 (b) (12) items did or did not cause a reduction of such taxes. Furthermore, a recovery exclusion is granted for certain other items which are described in section 22 (b) (12) (E). The recovery exclusion on account of such other items shall be determined under the principles set forth in this section with respect to section 22 (b) (12) items.

§ 39.22 (b) (13) *Statutory provisions; exclusions from gross income; additional allowance for certain members of the armed forces.*

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 chapter: * * *

(13) *Additional allowance for certain members of the armed forces*—(A) *Enlisted personnel.* Compensation received for active service as a member below the grade of commissioned officer in the armed forces of the United States for any month during any part of which such member—

(i) Served in a combat zone after June 24, 1950, and prior to January 1, 1954, or

(ii) Was hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone prior to January 1, 1954; but this clause shall not apply for any month during any part of which there are no combatant activities in any combat zone as determined under subparagraph (C) (iii) of this paragraph.

(B) *Commissioned officers.* So much of the compensation as does not exceed $200 received for active service as a commissioned officer in the armed forces of the United States for any month during any part of which such officer—

(i) Served in a combat zone after June 24, 1950, and prior to January 1, 1954, or

(ii) Was hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone prior to January 1, 1954; but this clause shall not apply for any month during any part of which there are no combatant activities in any combat zone as determined under subparagraph (C) (iii) of this paragraph.

(C) *Definitions.* For the purposes of this paragraph—

(i) The term "commissioned officer" does not include a commissioned warrant officer;

(ii) The term "combat zone" means any area which the President of the United States by Executive Order designates, for the purposes of this paragraph, as an area in which armed forces of the United States are or have (after June 24, 1950) engaged in combat;

(iii) Service is performed in a combat zone only if performed on or after the date designated by the President by Executive Order as the date of the commencing of combatant activities in such zone, and on or before the date designated by the President by Executive Order as the date of the termination of combatant activities in such zone, except that June 25, 1950, shall be considered the date of the commencing of combatant activities in the combat zone designated in Executive Order 10195; and

(iv) The term "compensation" does not include pensions and retirement pay.

[Sec. 22 (b) (13) as added by sec. 117, Rev. Act 1942, amended by sec. 7 (a), Current Tax Payment Act 1943; sec. 141 (a), Rev. Act 1945; sec. 7, Pub. Law 384 (80th Cong.); sec. 202 (a), Rev. Act 1950; sec. 305 (a), (b), Rev. Act 1951]

§ 39.22 (b) (13)-1 *Compensation of members of the armed forces of the United States for service in a combat zone before January 1, 1954, or for service while hospitalized as a result of such combat-zone service.* (a) In addition to the exemptions and credits otherwise applicable, section 22 (b) (13) provides that there shall be excluded from gross income:

(1) Compensation received for active service as a member below the grade of commissioned officer in the armed forces of the United States for any month during any part of which such member (i) served in a combat zone before January 1, 1954, or (ii) was hospitalized at any place as a result of wounds, disease, or injury incurred while so serving provided that during all of such month there are combatant activities in some combat zone.

(2) In the case of compensation received for active service as a commissioned officer in the armed forces of the United States for any month during any part of which such officer (i) served in a combat zone before January 1, 1954, or (ii) was hospitalized at any place as a result of wounds, disease, or injury incurred while so serving provided that during all of such month there are combatant activities in some combat zone, so much of such compensation as does not exceed $200.

(b) The exclusions under section 22 (b) (13) and this section are applicable only if active service is performed in a combat zone before January 1, 1954. Compensation is subject to exclusion whether or not it is received outside a combat zone or while the recipient is hospitalized or in a year (including a year after 1953) different from that in which the service was rendered for which the compensation is paid. Service is performed in a combat zone only if it is performed in an area which the President of the United States has designated by Executive order, for the purpose of section 22 (b) (13), as an area in which armed forces of the United States are or have engaged in combat, and only if it is performed on or after the date designated by the President by Executive order as the date of the commencing of combatant activities in such zone (except that the date June 25, 1950, in the combat zone designated in Executive Order 10195, shall be considered the date of the commencing of combatant activities in such zone) and on or before the date designated by the President by Executive order as the date of the termination of combatant activities in such zone. If a member of the armed forces serves in a combat zone or is hospitalized for any part of a month, he is entitled to the exclusion for such month to the same extent as if he had served in such zone, or had been hospitalized, for the entire month.

(c) If an individual is hospitalized for a wound, disease, or injury while serving in a combat zone, the wound, disease, or injury will, unless the contrary clearly appears, be presumed to have been incurred while serving in a combat zone. In certain cases, however, a wound, disease, or injury may have been incurred while serving in a combat zone even though the individual was not hospitalized for it while so serving. And, in exceptional cases, a wound, disease, or injury will not have been incurred while serving in a combat zone even though the individual was hospitalized for it while so serving.

(d) These principles may be illustrated by the following examples:

Example (1). An individual is hospitalized in a combat zone for a specific disease after having served in such zone for three weeks. The incubation period of such disease is from two to four weeks. Such disease was incurred while serving in the combat zone.

Example (2). The facts are the same as in example (1) except that the incubation period is one year. Such disease was not incurred while serving in the combat zone.

Example (3). A member of the Air Force, stationed outside the combat zone, is shot while participating in an aerial flight over the combat zone, but is not hospitalized until he returns to his home base. Such injury was incurred while serving in a combat zone.

Example (4). An individual is hospitalized for a specific disease three weeks after having departed from a combat zone. The incubation period of such disease is from two to four weeks. Such disease was incurred while serving in a combat zone.

(e) An individual is hospitalized only until such time as his status as a hospital patient ceases by reason of his discharge from the hospital.

(f) The term "commissioned officer" does not include a commissioned warrant officer, and, accordingly, a commissioned warrant officer is entitled to

the exclusion allowed to enlisted personnel under section 22 (b) (13) (A) The term "compensation", for the purpose of this section, does not include pensions and retirement pay. As to who are members of the armed forces, see § 39.3797-11.

(g) These exclusions are applicable without regard to the marital status of the recipient of the compensation, and if a husband and wife both meet the requirements of the statute, then each is entitled to the benefit of an exclusion. In the case of a husband and wife domiciled in a State recognized for Federal income tax purposes as a community property State, any exclusion from gross income under section 22 (b) (13) operates before apportionment of the gross income of the spouses in accordance with community property law. For example, a man and his wife are domiciled in a community property State and he is entitled, as a commissioned officer, to the benefit of the exclusion of $200 for each month under section 22 (b) (13) (B) He receives $1,000 as compensation for active service for three months in a combat zone. Of such amount, $600 is excluded from gross income under section 22 (b) (13) (B) and only $400 is taken into account in determining the gross income of both husband and wife.

(h) A member of the armed forces is in active service if he is actually serving in the armed forces. Periods during which a member of the armed forces is absent from duty on account of sickness, wounds, leave, internment by the enemy, or other lawful cause are periods of active service. A member of the armed forces in active service in a combat zone who there becomes a prisoner of war or missing in action is deemed, for the purpose of section 22 (b) (13) and this section, to continue in active service in the combat zone for the period for which he is entitled to such status for military pay purposes. These exclusions apply to compensation received by a member of the armed forces for services rendered while in active service even though payment is received subsequent to discharge or release from active service. Compensation credited to a decedent's account for a period subsequent to the established date of his death and received by his estate will be excluded under section 22 (b) (13) from the gross income of the estate to the same extent that it would have been excluded from the gross income of the decedent if he had lived and received such compensation.

§ 39.22 (b) (14) *Statutory provisions; exclusions from gross income; mustering-out payments for military and naval personnel.*

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 chapter: * * *

(14) *Mustering-out payments for military and naval personnel.* Amounts received during the taxable years as mustering-out payments with respect to service in the military or naval forces of the United States.

[Sec. 22 (b) (14) as added by sec. 109, Rev. Act 1943]

§ 39.22 (b) (14)-1 *Mustering-out payments of military and naval forces.* For the purposes of the exclusion from gross income under section 22 (b) (14) of mustering-out payments with respect to service in the military or naval forces, mustering-out payments are payments made to any recipients pursuant to the provisions of the Mustering-Out Payment Act of 1944 (38 U. S. C. 691e)

§ 39.22 (b) (15) *Statutory provisions; exclusions from gross income; payments to encourage exploration, development, and mining for defense purposes.*

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 chapter: * * *

(15) *Payments to encourage exploration, development, and mining for defense purposes.* An amount paid to a taxpayer by the United States (or any agency or instrumentality thereof), whether by grant or loan, and whether or not repayable, for the encouragement of exploration, development or mining of critical and strategic minerals or metals pursuant to or in connection with any undertaking approved by the United States (or any of its agencies or instrumentalities) and for which an accounting is made or required to be made to an appropriate governmental agency, and the forgiveness or discharge of any of such amount. Any expenditures (other than expenditures made after the repayment of such grant or loan) attributable to such grant, or loan shall not be deductible by the taxpayer as an expense nor increase the basis of the taxpayer's property either for determining gain or loss on sale, exchange, or other disposition or for computing depletion or depreciation, but upon the repayment of any portion of any such grant or loan which has been expended in accordance with the terms thereof such deductions and such increase in basis shall to the extent of such repayment be allowed as if made at the time of such repayment.

[Sec. 22 (b) (15) as added by sec. 306, Excess Profits Tax Act 1950]

§ 39.22 (b) (15)-1 *Payments to encourage exploration, development, and mining for defense purposes*—(a) *Applicability of section 22 (b) (15)* Section 22 (b) (15) is applicable only to amounts (1) which are paid to a taxpayer (i) by the United States or by an agency or instrumentality of the United States; (ii) as a grant, gift, bounty, bonus, premium, incentive, subsidy, loan, or advance; (iii) for the encouragement of exploration for, or development or mining of, a critical and strategic mineral or metal; and (iv) pursuant to or in connection with an undertaking by the taxpayer to explore for, or develop or produce, such mineral or metal and to expend or use any amounts so received for the purpose and in accordance with the terms and conditions upon which such amounts are paid, which undertaking has been approved by the United States or by an agency or instrumentality of the United States; and (2) for which the taxpayer has accounted, or is required to account, to an appropriate agency of the United States Government for the expenditure or use thereof for the purpose and in accordance with the terms and conditions upon which such amounts are paid. Section 22 (b) (15) is applicable only to an amount which meets each test or requirement set forth above. The section is applicable whether or not the payee is obligated to repay to the United States any portion or all of the amount so received. However, section 22 (b) (15) is not applicable to any loan or advance for the repayment of which the borrower's liability is unconditional and legally enforceable. Nor is section 22 (b) (15) applicable to any part of the purchase price of a critical and strategic mineral or metal received, whether before, on, or after delivery, by the seller from the United States or any agency or instrumentality thereof, irrespective of whether such purchase price is below, at, or above the established ceiling or currently prevailing market price. A payment of a separate and specific amount for the encouragement of exploration for, or development or mining of, a critical and strategic mineral or metal shall not be considered to be a part of the purchase price of such mineral or metal merely because such payment is added to, or included with, the payment of such purchase price. As used in section 22 (b) (15) and this section, the term "critical and strategic minerals or metals" means those minerals and metals listed in section 450 (b), as well as such other minerals and metals as are certified pursuant to such section as being essential to the defense effort of the United States and as not having been normally produced in appreciable quantities within the United States, and such other minerals and metals as are considered by those departments, agencies, and instrumentalities of the United States charged with the encouragement of exploration for, and development and mining of, critical and strategic minerals and metals to constitute critical and strategic minerals and metals for that purpose. See, for example, section 7 of Order-1 of the Defense Minerals Exploration Administration, March 7, 1952, 17 F R. 2090.

(b) *Exclusion from gross income.* Any amount to which section 22 (b) (15) is applicable is, by the terms of such section, excluded from gross income. Section 22 (b) (15) also excludes from gross income any income attributable to the forgiveness or discharge of any indebtedness to which such section is applicable.

(c) *Expense deduction, basis for gain or loss, depletion, or depreciation.* Except as hereinafter provided, any expenditure attributable to an amount received by a taxpayer to which section 22 (b) (15) is applicable shall not be deductible by the taxpayer as an expense under section 23, nor shall any such expenditure increase the basis under section 113 of the taxpayer's property either for determining gain or loss on sale, exchange, or other disposition or for computing depletion or depreciation (including amortization under section 124A) Upon the repayment of any portion of any amount to which section 22 (b) (15) is applicable and which has been expended for the purpose and in accordance with the terms and conditions upon which it was paid to the taxpayer, any

expenditures attributable to such amount made by the taxpayer shall, as provided in section 23, be allowed to the taxpayer as a deduction, and any such expenditures shall, as provided in section 113, increase the basis of the taxpayer's property, to the extent of such repayment as if such expenditures had been made at the time of such repayment. Such expenditures shall to the extent of the repayment be expensed or capitalized, as the case may be, in the order in which they were actually made or in such other manner as may be adopted by the taxpayer with the approval of the Commissioner.

§ 39.22 (b) (16) *Statutory provisions; exclusions from gross income; sports programs conducted for the American National Red Cross.*

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 chapter: * * *

(16) *Sports programs conducted for the American National Red Cross.* In the case of a taxpayer which is a corporation primarily engaged in the furnishing of sports programs, amounts received as proceeds from a sports program conducted by the taxpayer if—

(A) The taxpayer agrees in writing with the American National Red Cross to conduct such sports program exclusively for the benefit of the American National Red Cross;

(B) The taxpayer turns over to the American National Red Cross the proceeds from such sports program, minus the expenses paid or incurred by the taxpayer (i) which would not have been so paid or incurred but for such sports program, and (ii) which would be allowable as deductions under section 23 (a) (1) (A) but for the last sentence thereof; and

(C) The facilities used for such program are not regularly used during the taxable year for the conduct of sports programs to which this paragraph applies.

As used in this paragraph, the term "proceeds from such sports program" includes all amounts paid for admission to the sports program, plus all proceeds received by the taxpayer from such program or activities carried on in connection therewith.

[Sec. 22 (b) (16) as added by sec. 1, Pub. Law 465 (82d Cong.)]

§ 39.22 (c) *Statutory provisions; gross income; inventories.*

SEC. 22 *Gross income.* * * *

(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.

§ 39.22 (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, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. 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 (including containers) title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), 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. (But see § 39.22 (d)-1.)

§ 39.22 (c)-2 *Valuation of inventories.* (a) 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.

(b) 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.

(c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 22 (c) are (1) cost and (2) cost or market, whichever is lower. (For inventories by dealers in securities, see § 39.22 (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 (1) or (2) 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.

(d) In respect of normal goods, whichever basis is adopted must be applied with reasonable consistency to the entire inventory except as to those goods inventoried under the last-in first-out method authorized by section 22 (d) or to animals inventoried under the elective "unit-livestock-price method" authorized by § 39.22 (c)-6. Taxpayers were given an option to adopt the basis of either (1) cost or (2) 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 § 39.41-2. 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 last-in first-out inventories. 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.

(e) 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.

(f) The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with the regulations in this part, 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, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

§ 39.22 (c)-3 *Inventories at cost.* Cost means: (a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(b) 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.

(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, (3) 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.

(d) 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 (1) farmers and raisers of livestock (see § 39.22 (c)-6) (2) 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 § 39.22 (c)-7) and (3) retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see § 39.22 (c)-8)

§ 39.22 (c)-4 *Inventories at cost or market, whichever is lower* (a) 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—

(1) Of goods purchased and on hand, and

(2) 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.

(b) 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.

(c) 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.

§ 39.22 (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 § 39.41-2. 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 section, as regularly inventorying 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.

§ 39.22 (c)-6 *Inventories of livestock raisers and other farmers.* (a) A farmer may make his return upon an inventory basis instead of the cash receipts and disbursements basis. It is optional with the taxpayer which of these methods of accounting is used, but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in section 39.41-2.

(b) In any change of accounting from the cash receipts and disbursements basis to an inventory basis, adjustments shall be made, at the option of the taxpayer, in accordance with one or the other of the two methods outlined in (1) and (2) below.

(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 livestock) 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 livestock, crops, and products at the beginning of the year; provided, however—

(i) That if any livestock, grain, or other property on hand at the beginning of the taxable year had 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;

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

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory basis may value their inventories according to the "farm-price method," and farmers raising livestock may value their inventories

of animals according to either the "farm-price method" or the "unit-livestock-price method."

(d) The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method." 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 § 39.41-2.

(e) The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the Commissioner upon examination of the taxpayer's return.

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

(g) A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for breeding, dairy, or draft purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each accounting year in accordance with the established unit prices, except that no increase is to be made in the year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in first-out method of valuing inventories must be applied.

(h) If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in § 39.41-2. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock without formal application for permission, but the classifications and unit prices selected are subject to approval by the Commissioner upon examination of the taxpayer's return. A livestock raiser who has adopted a constant unit price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the "unit-livestock-price method."

(i) 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 agreement 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.

§ 39.22 (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, sizes, or grades of product. See section 22 (d) as to last-in first-out inventories.

§ 39.22 (c)-8 *Inventories of retail merchants.* (a) Retail merchants who employ what is known as the "retail method" of pricing inventories may make their returns upon that basis, provided that the use of such method is designated upon the return, that accurate accounts are kept, and that such method is consistently adhered to unless a change is authorized by the Commissioner as provided in § 39.41-2. 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—

(1) The total of the retail selling prices of the 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

(2) The cost of the goods included in the opening inventory plus the cost of the goods purchased during the year, bears to (1).

The result 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.

(b) For further adjustments to be made in the case of a retail merchant using the last-in first-out inventory method authorized by section 22 (d), see § 39.22 (d)-1.

(c) 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.

(d) A taxpayer (other than one using the last-in first-out inventory method) who previously has determined inventories in accordance with the foregoing, except that, to obtain a basis of approximate cost or market, whichever is lower, the practice has been followed, consistently and uniformly, of adjusting the retail selling prices of the goods included in the opening inventory and purchased during the year for mark-ups but not for mark-downs, may continue such practice subject to the conditions prescribed in this section. The adjustments must be bona fide and consistent and uniform. Where mark-downs are not included in the adjustments, mark-ups made to cancel or correct mark-downs shall not be included; and the mark-ups included must be reduced by the mark-downs made to cancel or correct such mark-ups.

(e) In no event shall mark-downs not based on actual reduction of retail sale prices, such as mark-downs based on depreciation and obsolescence, be recognized in determining the retail selling prices of the goods on hand at the end of the year.

(f) A taxpayer (other than one using the last-in first-out inventory method) who previously has determined inventories without following the practice of eliminating mark-downs in making adjustments to retail selling prices, may adopt such practice, provided permission to do so is obtained in accordance with, and subject to the terms provided by, § 39.41-2. A taxpayer filing a first return of income may adopt such practice subject to approval by the Commissioner upon examination of the return.

(g) A taxpayer using the last-in first-out inventory method in conjunction with retail computations must adjust retail selling prices for mark-downs as well as mark-ups, in order that there may be reflected the approximate cost of the goods on hand at the end of the year regardless of market values.

§ 39.22 (d) *Statutory provisions; gross income; last-in first-out inventory method.*

SEC. 22. *Gross income.* * * *

(d) [Last-in first-out inventory method.] (1) A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c)) in inventorying goods specified in the application required under paragraph (2)

(A) Inventory them at cost;

(B) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year; and

(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.

(2) The method described in paragraph (1) may be used—

(A) Only in inventorying goods (required under subsection (c) to be inventoried) specified in an application to use such method filed at such time and in such manner as the Commissioner may prescribe; and

(B) Only if the taxpayer establishes to the satisfaction of the Commissioner that the taxpayer has used no procedure other than that specified in subparagraphs (B) and (C) of paragraph (1) in inventorying such goods to ascertain the income, profit, or loss of the first taxable year for which the method described in paragraph (1) is to be used, for the purpose of a report or statement covering such taxable year (i) to shareholders, partners, or other proprietors, or to beneficiaries, or (ii) for credit purposes.

(3) The change to, and the use of, such method shall be in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe as necessary in order that the use of such method may clearly reflect income.

(4) In determining income for the taxable year preceding the taxable year for which such method is first used, the closing inventory of such preceding year of the goods specified in such application shall be at cost.

(5) If a taxpayer, having complied with paragraph (2), uses the method described in paragraph (1) for any taxable year, then such method shall be used in all subsequent taxable years unless—

(A) With the approval of the Commissioner a change to a different method is authorized; or

(B) The Commissioner determines that the taxpayer has used for any such subsequent taxable year some procedure other than that specified in subparagraph (B) of paragraph (1) in inventorying the goods specified in the application to ascertain the income, profit, or loss of such subsequent taxable year for the purpose of a report or statement covering such taxable year (i) to shareholders, partners, or other proprietors, or beneficiaries, or (ii) for credit purposes; and requires a change to a method different from that prescribed in paragraph (1) beginning with such subsequent taxable year or any taxable year thereafter.

In either of the above cases, the change to, and the use of, the different method shall be in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe as necessary in order that the use of such method may clearly reflect income.

(6) *Involuntary liquidation and replacement of inventory*—(A) *Adjustment of net income and resulting tax; years beginning prior to January 1, 1948.* If, for any taxable year beginning after December 31, 1940, and prior to January 1, 1948, the closing inventory of a taxpayer inventorying goods under the method provided in this subsection reflects a decrease from the opening inventory of such goods for such year, and if the taxpayer elects at such time and in such manner and subject to such regulations as the Commissioner with the approval of the Secretary may prescribe, to have the provisions of this paragraph apply, and if it [is] established to the satisfaction of the Commissioner, in accordance with such regulations, that such decrease is attributable to the involuntary liquidation of such inventory as defined in subparagraph (B), and if the closing inventory of a subsequent taxable year, ending prior to January 1, 1953, reflects a replacement, in whole or in part, of the goods so previously liquidated, the net income of the taxpayer otherwise determined for the year of such involuntary liquidation shall be adjusted as follows:

(i) Increased by an amount equal to the excess, if any, of the aggregate cost of such goods reflected in the opening inventory of the year of involuntary liquidation over the aggregate replacement cost; or

(ii) Decreased by an amount equal to the excess, if any, of the aggregate replacement cost of such goods over the aggregate cost thereof reflected in the opening inventory of the year of the involuntary liquidation.

The taxes imposed by this chapter and by chapter 2 for the year of such liquidation, for preceding taxable years, and for all taxable years intervening between the year of liquidation and the year of replacement shall be redetermined, giving effect to such adjustments. Any increase in such taxes resulting from such adjustments shall be assessed and collected as a deficiency but without interest, and any overpayment so resulting shall be credited or refunded to the taxpayer without interest.

(B) *Definition of involuntary liquidation.* The term "involuntary liquidation" as used in this paragraph, means the sale or other disposition of goods inventoried under the method described in this subsection, either voluntary or involuntary, coupled with a failure on the part of the taxpayer to purchase, manufacture, or otherwise produce and have on hand at the close of the taxable year in which such sale or other disposition occurred such goods as would, if on hand at the close of such taxable year, be subject to the application of the provisions of this subsection, if such failure on the part of the taxpayer is due, directly and exclusively, (i) to enemy capture or control of sources of limited foreign supply; (ii) to shipping or other transportation shortages; (iii) to material shortages resulting from priorities or allocations; (iv) to labor shortages; or (v) to other prevailing war conditions beyond the control of the taxpayer.

(C) *Replacements.* If, in the case of any taxpayer subject to the provisions of subparagraph (A), the closing inventory of the taxpayer for a taxable year, subsequent to the year of involuntary liquidation but prior to the complete replacement of the goods so liquidated, reflects an increase over the opening inventory of such goods for the taxable year, the goods reflecting such increase shall be considered, in the order of their acquisition, as having been acquired in replacement of the goods most recently liquidated (whether or not in a year of involuntary liquidation) and not previously replaced, and if the liquidation was an involuntary liquidation shall be taken into purchases and included in the closing inventory of the taxpayer for the year of replacement at the inventory cost basis of the goods replaced.

(D) *Election irrevocable.* An election by the taxpayer to have the provisions of this paragraph apply, once made, shall be irrevocable and shall be binding for the year of the involuntary liquidation and for all determinations for prior and subsequent taxable years insofar as they are related to the year of liquidation or replacement.

(E) *Adjustment in certain cases.* If the adjustments specified in subparagraph (A) are, with respect to any taxable year, prevented, on the date of the filing of the income tax return of the taxpayer for the year of the replacement, or within three years from such date, by any provision or rule of law (other than this subparagraph and other than section 3761, relating to compromises), such adjustments shall nevertheless be made if, in respect of the taxable year for which the adjustment is sought, a notice of deficiency is mailed or a claim for refund is filed, as the case may be, within three years after the date of the filing of the income tax return for the year of replacement. If, at the time of the mailing of such notice of deficiency or the filing of such claim for refund, the adjustment is so prevented, then the amount of the adjustment authorized by this paragraph shall be limited to the increase or decrease of the tax imposed by this chapter and Chapter 2 previously determined for such taxable year which results solely from the effect of subparagraph (A), and such amount shall be assessed and collected, or credited or refunded, in the same manner as if it were a deficiency or an overpayment, as the case may be, for such taxable year and as if, on the date of the filing of the income tax return for the year of the replacement, three years remain before the expiration of the periods of limitation upon assessment or the filing of claim for refund for the taxable year. The tax previously determined shall be ascertained in accordance with section 734 (d). The amount to be assessed and collected under this paragraph in the same manner as if it were a deficiency or to be credited or refunded in the same manner as if it were an overpayment shall not be diminished by any credit or set-off based upon any item, inclusion, deduction, credit, exemption, gain, or loss, other than one resulting from the effect of subparagraph (A). Such amount, if paid, shall not be recovered by a claim or suit for refund, or suit for erroneous refund based upon any item, inclusion, deduction, credit, exemption, gain, or loss, other than one resulting from the effect of subparagraph (A).

(F) *Years ending after June 30, 1950, and prior to January 1, 1954*—(i) *Adjustment of net income and resulting tax.* If, for any taxable year ending after June 30, 1950, and prior to January 1, 1954, the closing inventory of a taxpayer inventorying goods under the method provided in this subsection reflects a decrease from the opening inventory of such goods for such year, and if the taxpayer elects, at such time and in such manner and subject to such regulations as the Commissioner with the approval of the Secretary may prescribe, to have the provisions of this paragraph apply, and if it is established to the satisfaction of the Commissioner, in accordance with such regulations, that such decrease is attributable to the involuntary liquidation of such inventory as defined in subparagraph (B) (as modified by clause (ii) of this subparagraph), and if the closing inventory of a subsequent taxable year, ending prior to January 1, 1956, reflects a replacement in whole or in part, of the goods so previously liquidated, the net income of the taxpayer otherwise determined for the year of such involuntary liquidations shall be increased by an amount equal to the excess, if any, of the aggregate cost of such goods reflected in the opening inventory of the year of involuntary liquidation over the aggregate replacement cost, or decreased by an amount equal to the excess, if any, of the aggregate replacement cost of such goods over the aggregate cost thereof reflected in the opening inventory of the year of the involuntary liquidation. The taxes imposed by this chapter and by chapter 2 for the year

of such liquidation, for preceding taxable years, and for all taxable years intervening between the year of liquidation and the year of replacement shall be redetermined, giving effect to such adjustments. Any increase in such taxes resulting from such adjustments shall be assessed and collected as a deficiency but without interest, and any overpayment so resulting shall be credited or refunded to the taxpayer without interest.

(ii) *Definition of involuntary liquidation.* ›r the purposes of this subparagraph the rm "involuntary liquidation" shall have ıe meaning given to it in subparagraph (B) ıd, in addition, it shall mean a failure, as ferred to in that subparagraph, on the part the taxpayer due, directly and exclusively, disruption of normal trade relations beveen countries. For the purposes of this ıbparagraph the words "enemy" and "war" used in subparagraph (B), shall be inter:eted, pursuant to regulations prescribed by ıe Secretary, in such a way as to apply to rcumstances, occurrences and conditions, cking a state of war, which are similar, by ason of a state of national preparedness, to ıose which would exist under a state of war.

(iii) *Application of subparagraphs (C) and E).* Subparagraphs (C) and (E), to the ktent that they refer to any taxpayer sub:ct to the provisions of subparagraph (A) or the adjustments specified in or resulting om the effect of subparagraph (A), shall be applicable to a taxpayer subject to the proisions of this subparagraph or to adjustıents specified in or resulting from the effect f this subparagraph as though they specifically referred to this subparagraph. If, for ny taxable year ending after June 30, 1950, nd prior to January 1, 1953, subparagraph C) is applicable with respect to involuntary quidations of goods of the same class sub:ct to the provisions of both subparagraph A) and this subparagraph, the involuntary quidations of such goods subject to the rovisions of this subparagraph shall be conidered for the purpose of subparagraph (C) s having occurred prior to the involuntary quidations of such goods subject to the proisions of subparagraph (A). For the purıose of this clause, and with respect to the axable years covered by this subparagraph, he reference in subparagraph (E) to section 34 (d) shall be taken as a reference to secion 452 (d).

Sec. 22 (d) as amended by sec. 219 (a), Rev. ıct 1939; sec. 118, sec. 119, Rev. Act 1942; ec. 110, Rev. Act 1943; Sec. 8, Pub. Law 384 80th Cong.); Pub. Law 756 (81st Cong.); ?ub. Law 919 (81st Cong.); sec. 306 (a), Rev. ıct 1951]

§ 39.22 (d)-1 *Last-in first-out inventories.* (a) Any taxpayer permitted or required to take inventories pursuant to the provisions of section 22 (c) and pursuant to the provisions of §§ 39.22 (c)-1 to 39.22 (c)-8, inclusive, may elect with respect to those goods specified in his application and properly subject to inventory to compute his opening and closing inventories in accordance with the method provided by section 22 (d). Under this last-in first-out inventory method, the taxpayer is permitted to treat those goods remaining on hand at the close of the taxable year as being:

(1) Those included in the opening inventory of the taxable year, in the order of acquisition and to the extent thereof, and

(2) Those acquired during the taxable year.

This last-in first-out inventory method is not dependent upon the character of the business in which the taxpayer is engaged, or upon the identity or want of identity through commingling of any of the goods on hand, and may be adopted by the taxpayer as of the close of any taxable year.

(b) If the last-in first-out inventory method is used by a taxpayer who regularly and consistently, in a manner similar to hedging on a futures market, matches purchases with sales, then firm purchases and sales contracts (i. e., those not legally subject to cancellation by either party) entered into at fixed prices on or before the date of the inventory may be included in purchases or sales, as the case may be, for the purpose of determining the cost of goods sold and the resulting profit or loss, provided that this practice is regularly and consistently adhered to by the taxpayer and that, in the opinion of the Commissioner, income is clearly reflected thereby.

(c) A manufacturer or processor who has adopted the last-in first-out inventory method as to a class of goods may elect to have such method apply to the raw materials only (including those included in goods in process and in finished goods) expressed in terms of appropriate units. If such method is adopted, the adjustments are confined to costs of the raw material in the inventory and the cost of the raw material in goods in process and in finished goods produced by such manufacturer or processor and reflected in the inventory.

Example (1). Assume the opening inventory had 10 units of raw material, 10 units of goods in process, and 10 units of finished goods and the raw material cost was 6 cents a unit, the processing cost 2 cents a unit, and overhead cost 1 cent a unit. For the purposes of this example, it is assumed that the entire amount of goods in process was 50 percent processed.

OPENING INVENTORY

	Raw material	Goods in process	Finished goods
Raw material	$0.60	$0.60	$0.60
Processing cost		.10	.20
Overhead		.05	.10

In the closing inventory there are 20 units of raw material, 6 units of goods in process, and 8 units of finished goods and the costs were—raw material 10 cents, processing cost 4 cents, and overhead 1 cent.

CLOSING INVENTORY

[Based on cost and prior to adjustment]

	Raw material	Goods in process	Finished goods
Raw material	$2.00	$0.60	$0.80
Processing costs		.12	.32
Overhead		.03	.08
Total	2.00	.75	1.20

There were 30 units of raw material in the opening inventory and 34 units in the closing inventory. The adjustment to the closing inventory would be as follows:

CLOSING INVENTORY AS ADJUSTED

	Raw material	Goods in process	Finished goods
Raw material:			
20 at 6 cents	$1.20		
6 at 6 cents		$0.36	
4 at 6 cents			$0.24
4 at 10 cents[1]			.40
Processing costs		.12	.32
Overhead		.03	.08
Total	1.20	.51	1.04

[1] This excess is subject to determination of price under section 22 (d) (1) (B) and § 39.22(d)-2. If the excess falls in goods in process, the same adjustment is applicable.

The only adjustment to the closing inventory is the cost of the raw material; the processing costs and overhead cost are not changed.

Example (2). Assume the opening inventory had 5 units of raw material, 10 units of goods in process, and 20 units of finished goods with the same prices as in example (1) and the closing inventory had 20 units of raw material, 20 units of goods in process, and 10 units of finished goods, with raw material costs as in the closing inventory in example (1). The adjusted closing inventory would be as follows in so far as the raw material is concerned:

Raw material, 20 at 6 cents	$1.20
Goods in process:	
15 at 6 cents	.90
5 at 10 cents[1]	.50
Finished goods:	
None at 6 cents	.00
10 at 10 cents[1]	1.00

[1] This excess is subject to determination of price under section 22 (d) (1) (B) and § 39.22 (d)-2.

The 20 units of raw material in the raw state plus 15 units of raw material in goods in process make up the 35 units of raw material that were contained in the opening inventory.

(d) For the purposes of this section, raw material in the opening inventory must be compared with similar raw material in the closing inventory. There may be several types of raw materials, depending upon the character, quality or price, and each type of raw material in the opening inventory must be compared with a similar type in the closing inventory.

(e) In the cotton textile industry there may be different raw materials depending upon marked differences in length of staple, in color or grade of the cotton. But where different staple lengths or grades of cotton are being used at different times in the same mill to produce the same class of goods, such differences would not necessarily require the classification into different raw materials.

(f) As to the pork packing industry a live hog is considered as being composed of various raw materials, different cuts of a hog varying markedly in price and use. Generally a hog is processed into approximately 10 primal cuts and several miscellaneous articles. However, due to similarity in price and use, these may be grouped into fewer classifications, each group being classed as one raw material.

(g) When the finished product contains two or more different raw materials as in the case of cotton and rayon mixtures, each raw material is treated

separately and adjustments made accordingly.

(h) Upon written notice addressed to the Commissioner by the taxpayer, a taxpayer who has heretofore adopted the last-in first-out inventory method in respect of any goods may adopt the method authorized in this section and limit the election to the raw material including raw materials entering into goods in process and in finished goods. If this method is adopted as to any specific goods, it must be used exclusively for such goods for any previous year (not closed by agreement) to which the previous election applies and all subsequent years, unless permission to change is granted by the Commissioner.

(i) The election may also be limited to that phase in the manufacturing process where a product is produced that is recognized generally as a salable product, as for example, in the textile industry where one phase of the process is the production of yarn. Since yarn is generally recognized as a salable product the election may be limited to that portion of the process when yarn is produced. In the case of copper and brass processors, the election may be limited to the production of bars, plates, sheets, etc., although these may be further processed into other products.

(j) The election may also apply to any one raw material, when two or more raw materials enter into the composition of the finished product, for example, in the case of cotton and rayon yarn the taxpayer may elect to inventory the cotton only. However, a taxpayer who has previously made an election to use the last-in first-out inventory method may not now elect to exclude any raw materials that were covered by such previous election.

(k) If a taxpayer using the retail method of pricing inventories, authorized by § 39.22 (c)-8, elects to use in connection therewith the last-in first-out inventory method authorized by section 22 (d) the apparent cost of the goods on hand at the end of the year, determined pursuant to § 39.22 (c)-8, shall be adjusted to the extent of price changes therein taking place subsequent to the close of the preceding taxable year. The amount of any apparent inventory increase or decrease to be eliminated in this adjustment shall be determined by reference to acceptable price indices established to the satisfaction of the Commissioner. Price indices prepared by the United States Bureau of Labor Statistics which are applicable to the goods in question will be considered acceptable to the Commissioner. Price indices which are based upon inadequate records, or which are not subject to complete and detailed audit within the Internal Revenue Service, will not be approved.

(l) If a taxpayer uses consistently the so-called "dollar-value" method of pricing inventories, or any other method of computation established to the satisfaction of the Commissioner as reasonably adaptable to the purpose and intent of section 22 (d) and if such taxpayer elects under section 22 (d) to use the last-in first-out inventory method authorized by such section, the taxpayer's opening and closing inventories shall be determined under section 22 (d) by the use of the appropriate adaptation.

§ 39.22 (d)-2 *Requirements incident to adoption and use of last-in first-out inventory method.* Except as otherwise provided in § 39.22 (d)-1 with respect to raw material computations, with respect to retail inventory computations, and with respect to "dollar-value" and other methods of computation established to the satisfaction of the Commissioner as reasonably adapted to the purpose and intent of section 22 (d) the adoption and use of the last-in first-out inventory method is, by section 22 (d) and the regulations thereunder, made subject to the following requirements:

(a) The taxpayer shall file an application to use such method specifying with particularity the goods to which it is to be applied.

(b) The inventory shall be taken at cost regardless of market values.

(c) Goods of the specified type included in the opening inventory of the taxable year for which the method is first used shall be considered as having been acquired at the same time and at a unit cost equal to the actual cost of the aggregate divided by the number of units on hand. The actual cost of the aggregate shall be determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the preceding taxable year with the exception that restoration shall be made with respect to any write-down to market values resulting from the pricing of former inventories.

(d) Goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be included in the closing inventory, regardless of identification with specific invoices and regardless of specific cost accounting records, at costs determined pursuant to the provisions of Rule 1 or Rule 2, dependent upon the character of the transactions in which the taxpayer is engaged:

(1) *Rule 1.* In the case of a taxpayer engaged in the purchase and sale of merchandise, such as a retail grocer or druggist, or engaged in the initial production of merchandise and its sale without processing, such as a miner selling his ore output without smelting or refining, such costs shall be determined—

(i) By reference to the actual cost of the goods most recently purchased or produced;

(ii) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(iii) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced, the goods reflected in such inventory increase being considered for the purposes of section 22 (d) as having been acquired all at the same time; or

(iv) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

Whichever of the several methods of valuing the inventory increase is adopted by the taxpayer and approved by the Commissioner shall be consistently adhered to in all subsequent taxable years so long as the last-in first-out inventory method is used by the taxpayer.

The application of Rule 1 may be illustrated by the following examples:

Example (1). Suppose that the taxpayer adopts the last-in first-out inventory method for the taxable year 1952 with an opening inventory of 10 units at 10 cents per unit, that it makes 1952 purchases of 10 units as follows:

	Units		Price		Amount
January	1	at	$0.11	=	$0.11
April	2	at	.12	=	.24
July	3	at	.13	=	.39
October	4	at	14	=	.56
Totals	10				1.30

and that it has a 1952 closing inventory of 15 units. This closing inventory, depending upon the taxpayer's method of valuing inventory increases, will be computed as follows:

(*a*) Most recent purchases—

	Units		Price			Amount
	10	at	$0.10		=	$1.00
	4	at	.14	(October)	=	.56
	1	at	.13	(July)	=	.13
Totals	15					1.69

or

(*b*) In order of acquisition—

	Units		Price			Amount
	10	at	$0.10		=	$1.00
	1	at	.11	(January)	=	.11
	2	at	.12	(April)	=	.24
	2	at	.13	(July)	=	.26
Totals	15					1.61

or

(*c*) At an annual average—

	Units		Price			Amount
	10	at	$0.10		=	$1.00
	5	at	.13	(130/10)	=	.65
Totals	15					1.65

Example (2). Suppose that the taxpayer's closing inventory for 1953, the year following that involved in example (1), reflects an inventory decrease for the year, and not an increase; suppose that there is, accordingly, a 1953 closing inventory of 13 units. Inasmuch as the decreased closing inventory will be determined wholly by reference to the 15 units reflected in the opening inventory for the year, and will be taken "in the order of acquisition" pursuant to section 22 (d) (1) (B), and inasmuch as the character of the taxpayer's opening inventory for the year will be dependent upon its method of valuing its 5-unit inventory increase for the preceding year, the closing inventory for 1953 will be computed as follows:

(*a*) In case the increase for the preceding taxable year was taken by reference to the most recent purchases—

	Units		Price			Amount
	10	at	$0.10	(from 1951)	=	$1.00
	1	at	.13	(July 1952)	=	.13
	2	at	.14	(October 1952)	=	.28
Totals	13					1.41

or

(b) In case the increase for the preceding taxable year was taken in the order of acquisition—

10 at $0.10 (from 1951)	=	$1.00
1 at .11 (January 1952)	=	.11
2 at .12 (April 1952)	=	.24
Totals 13		1.35

(c) In case the increase for the preceding taxable year was taken on the basis of an average—

10 at $0.10 (from 1951)	=	$1.00
3 at .13 (from 1952)	=	.39
Totals 13		1.39

(2) *Rule 2*. In the case of a taxpayer engaged in manufacturing, fabricating, processing, or otherwise producing merchandise, such costs shall be determined —

(i) In the case of raw materials purchased or initially produced by the taxpayer, in the manner elected by the taxpayer under Rule 1 to the same extent as if the taxpayer were engaged in purchase and sale transactions;

and

(ii) In the case of goods in process, regardless of the stage to which the manufacture, fabricating, or processing may have advanced, and in the case of finished goods, pursuant to any proper method which, in the opinion of the Commissioner, clearly reflects income.

(e) The taxpayer shall establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining income, profit, or loss for the taxable year for which the last-in first-out inventory method is first used or for any subsequent taxable year, for credit purposes or for the purpose of reports to shareholders, partners, or other proprietors, or to beneficiaries, has not used any inventory method other than that referred to in § 39.22 (d)-1 or at variance with the requirement referred to in paragraph (c) of this section, the taxpayer's use of market value in lieu of cost or his issuance of reports or credit statements covering a period of operations less than the whole of the taxable year not being considered at variance with this requirement.

(f) Goods of the specified type on hand as of the close of the taxable year preceding the taxable year for which this inventory method is first used shall be included in the taxpayer's closing inventory for such preceding taxable year at cost determined in the manner prescribed in paragraph (c) of this section.

(g) The last-in first-out inventory method, once adopted by the taxpayer with the approval of the Commissioner, shall be adhered to in all subsequent taxable years unless—

(1) A change to a different method is approved by the Commissioner; or

(2) The Commissioner determines that the taxpayer, in ascertaining income, profit, or loss for the whole of any taxable year subsequent to his adoption of the last-in first-out inventory method, for credit purposes or for the purpose of reports to shareholders, partners, or other proprietors, or to beneficiaries, has used any inventory method at variance with that referred to in § 39.22 (d)-1 and requires of the taxpayer a change to a different method for such subsequent taxable year or any taxable year thereafter.

(h) The records and accounts employed by the taxpayer in keeping his books shall be maintained in conformity with the inventory method referred to in § 39.22 (d)-1, and such supplemental and detailed inventory records shall be maintained as will enable the Commissioner readily to verify the taxpayer's inventory computations as well as his compliance with these several requirements.

§ 39.22 (d)-3 *Time and manner of making election*. (a) The last-in first-out inventory method may be adopted and used only if the taxpayer files with his return for the taxable year as of the close of which the method is first to be used, in triplicate on Form 970, and pursuant to the instructions printed thereon and to the requirements of this section, a statement of his election to use such inventory method. Such statement shall be accompanied by an analysis of all inventories of the taxpayer as of the beginning and as of the end of the taxable year for which the last-in first-out inventory method is proposed first to be used, and also as of the beginning of the preceding taxable year. In the case of a manufacturer, this analysis shall show in detail the manner in which costs are computed with respect to raw materials, goods in process, and finished goods, segregating the products (whether in process or finished goods) into natural groups on the basis of either (1) similarity in factory processes through which they pass, or (2) similarity of raw materials used, or (3) similarity in style, shape, or use finished products. Each group of products shall be clearly described.

(b) The taxpayer shall submit for the consideration of the Commissioner in connection with the taxpayer's adoption or use of the last-in first-out inventory method such other detailed information with respect to his business or accounting system as may be at any time requested by the Commissioner.

(c) As a condition to the taxpayer's use of the last-in first-out inventory method, the Commissioner may require that the method be used with respect to goods other than those specified in the taxpayer's statement of election if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income.

(d) Whether or not the taxpayer's application for the adoption and use of the last-in first-out inventory method should be approved, and whether or not such method, once adopted, may be continued, and the propriety of all computations incidental to the use of such method will be determined by the Commissioner in connection with the examination of the taxpayer's returns.

§ 39.22 (d)-4 *Adjustments to be made by taxpayer* A taxpayer may not change to the last-in first-out method of taking inventories unless, at the time he files his application for the adoption of such method, he agrees to such adjustments incident to the change to or from such method, or incident to the use of such method, in the inventories of prior taxable years or otherwise, as the Commissioner upon the examination of the taxpayer's returns may deem necessary in order that the true income of the taxpayer will be clearly reflected for the years involved.

§ 39.22 (d)-5 *Revocation of election*. An election made to adopt and use the last-in first-out inventory method is irrevocable, and the method once adopted shall be used in all subsequent taxable years, unless the use of another method be required by the Commissioner, or authorized by him pursuant to a written application therefor filed with him as provided in § 39.41-2.

§ 39.22 (d)-6 *Change from last-in first-out inventory method*. If the taxpayer is granted permission by the Commissioner to discontinue the use of last-in first-out method of taking inventories, and thereafter to pursue some other method, or if the taxpayer is required by the Commissioner to discontinue the use of the last-in first-out method by reason of the taxpayer's failure to conform to the requirements detailed in § 39.22 (d)-2, the inventory of the specified goods for the first taxable year affected by the change and for each taxable year thereafter shall be taken—

(a) In conformity with the method used by the taxpayer under section 22 (c) in inventorying goods not included in his last-in first-out inventory computations; or

(b) If the last-in first-out inventory method was used by the taxpayer with respect to all of his goods subject to inventory, then in conformity with the inventory method used by the taxpayer prior to his adoption of the last-in first-out inventory method; or

(c) If the taxpayer had not used inventories prior to his adoption of the last-in first-out inventory method and had no goods currently subject to inventory by a method other than the last-in first-out inventory method, then in conformity with such inventory method as may be selected by the taxpayer and approved by the Commissioner as resulting in a clear reflection of income; or

(d) In any event, in conformity with any inventory method to which the taxpayer may change pursuant to application approved by the Commissioner.

§ 39.22 (d)-7 *Involuntary liquidation and replacement*. (a) If prevailing war conditions beyond the control of the taxpayer, or certain prescribed post-war conditions beyond his control, should render it impossible either during the period of the war or within the prescribed post-war period for a taxpayer using the last-in first-out inventory method to have on hand at the close of the taxable year a stock of merchandise in kind and description like that included in the opening inventory for the

year, or in a quantity equal to that of the opening inventory, the resulting inventory decrease for the year will be regarded, at the election of the taxpayer, as reflecting an involuntary liquidation subject to replacement. If the taxpayer notifies the Commissioner at any time not later than six months after the time of filing his income tax return for the year of the liquidation, or at any time not later than December 15, 1952, in the case of the year of liquidation being a taxable year ending before March 1, 1952, that he intends to effect a replacement of the liquidated stock, in whole or in part, and that he desires to have applied in his case the involuntary liquidation and replacement provisions of section 22 (d) (6) and if he establishes to the satisfaction of the Commissioner the involuntary character of the liquidation to which his stock has been subjected, effect shall be given, when replacement has been made, to an adjustment of net income for the year of liquidation to the extent of the difference between the replacement costs incurred and the original inventory cost of the base stock inventory liquidated. For extensions of time, see Subpart G of the regulations in this part. If the replacement costs exceed such inventory costs, the net income of the taxpayer otherwise computed shall be reduced by an amount equal to such excess. If the replacement costs are less than the inventory costs, net income otherwise computed shall be increased to the extent of such difference. Any deficiency in the income or excess profits tax of the taxpayer, or any overpayment of such taxes, attributable to such adjustment shall be assessed and collected by the Commissioner or credited or refunded to the taxpayer without interest.

(b) The statutory provisions affording recognition to the involuntary character of inventory decreases which become apparent in war years and authorizing for tax purposes a replacement of the items of merchandise so liquidated are limited in their application to liquidations occurring in taxable years beginning before January 1, 1948, and to inventory replacements effected in taxable years ending before January 1, 1953. The statutory provisions affording recognition to the involuntary character of inventory decreases which become apparent in post-war taxable years and authorizing for tax purposes a replacement of the items of merchandise so liquidated are limited in their application to liquidations occurring in taxable years ending after June 30, 1950, and before January 1, 1954, and to inventory replacements effected in taxable years ending before January 1, 1956.

(c) With respect to inventory decreases occurring during the period of the war, a failure on the part of the taxpayer to have on hand in his closing inventory for the taxable year merchandise of the kind, description, and quantity of that reflected in his opening inventory will be considered as an involuntary liquidation only if it is established to the satisfaction of the Commissioner that such failure is due wholly to his inability to purchase, manufacture, or otherwise produce and procure delivery of such merchandise during the taxable year of liquidation by reason of prevailing war conditions, such as (1) enemy capture or control of sources of limited foreign supply (2) shipping or other transportation shortages; (3) material shortages resulting from priorities or allocations; (4) labor shortages; and (5) similar war conditions beyond the control of the taxpayer. A voluntary shift by the taxpayer, in the exercise of business judgment, to merchandise of a different character, description, or use, or to merchandise processed out of a substantially different kind of raw materials while raw materials of the type originally used are still available will not be considered as an involuntary liquidation notwithstanding the fact that such a shift in merchandise stocked was prompted by a shifting market demand attributable to war conditions. The term "involuntary liquidation" presupposes a physical inability to maintain a normal inventory as distinguished from a financial or business disinclination on the part of the taxpayer to do so.

(d) With respect to inventory decreases occurring in taxable years ending after June 30, 1950, and before January 1, 1954, the rules prescribed in paragraph (c) of this section shall apply. For the purpose of such rules, the words "enemy" and "war" shall be interpreted to apply to circumstances, occurrences, and conditions lacking a state of war, which are similar, by reason of a state of national preparedness, to those which would exist under a state of war. The various directives, orders, regulations, and allotments issued by the Federal Government in connection with national preparedness are among such circumstances and conditions. Likewise, a voluntary compliance with a request of an authorized representative of the Federal Government made upon an industry or an important segment thereof, or a voluntary allocation of materials by an industry or important segment thereof sanctioned by the Federal Government, if made in connection with the national preparedness program, might be considered as such a circumstance or condition. Similarly, so much of an inventory decrease as is directly and exclusively attributable to the Federal Government's stockpiling program for periods during which an item is not subject to allotment shall also be considered as subject to the provisions of section 22 (d) (6) Thus, so much of an inventory decrease as is due wholly to the effect of directives, orders, regulations, or allotments issued pursuant to the Defense Production Act of 1950, as amended (50 U. S. C. App. 2061) or to any other circumstance or condition which is solely dependent upon other action taken by the Federal Government in furtherance of the national preparedness program, ordinarily shall be considered as an involuntary liquidation under section 22 (d) (6) and this section; however, to the extent that such a decrease is due to the disposition of goods acquired in violation of such directives, orders, regulations, or allotments, such decrease shall not be considered as such an involuntary liquidation. With respect to an inventory decrease in a taxable year ending after June 30, 1950, and before January 1, 1954, due directly and exclusively to a disruption of normal trade relations between countries, such an inventory decrease shall be considered as an involuntary liquidation subject to the rules and requirements prescribed in the preceding paragraphs, including the requirement that the taxpayer establish to the satisfaction of the Commissioner the cause of the involuntary liquidation. A disruption of normal trade relations between countries may be reflected by unusual export limitations imposed by a foreign government, by unusual exchange restrictions, or by other unusual circumstances or conditions beyond the control of the taxpayer.

(e) If the taxpayer would have the involuntary liquidation and replacement provisions applicable with respect to any inventory decrease, he musts so elect within the time prescribed by the regulations in this part. In making such election, the taxpayer shall attach to his return and make a part thereof, or he shall furnish separately to the Commissioner, a statement setting forth the following matters: (1) The wish of the taxpayer to invoke the involuntary liquidation and replacement provisions; (2) a detailed list or other identifying description of the items of merchandise claimed to have been subjected to involuntary liquidation and the extent to which replacement is intended; (3) the circumstances relied upon as rendering the taxpayer unable to maintain throughout the taxable year a normal inventory of the items involved, including evidence of the applicable National Production Authority inventory control figures for the beginning and the close of the taxable year (or if none, a statement to that effect), allotments applied for, allotments received, and reason for failure to place allotments received; (4) detailed proof of such circumstances to the extent that they may not be the subject-matter of common knowledge; (5) a full description of what efforts were made on the part of the taxpayer to effect replacement during the taxable year and the result of such efforts; and (6) in the case of an election made pursuant to an extension of time sought under Subpart G of the regulations in this part more than six months after the filing of the return for the year of liquidation, the circumstances relied upon as justifying the election at such time, together with a disclosure of the extent, if any to which replacements have already been made.

(f) The election of the taxpayer to treat an involuntary decrease of inventory as subject to the replacement adjustments is to be exercised separately for each taxable year reflecting such a decrease, and the election, once exercised with respect to a given year, shall be irrevocable with respect to the particular decrease involved and its replacement,

and shall be binding for the year of liquidation, the year of replacement, and all prior, intervening, and subsequent years to the extent that such prior, intervening, and subsequent years are affected by the adjustments authorized. The ultimate replacement and the resulting adjustment for the year of liquidation may have consequences, among others, in the earnings and profits of intervening years and the inventory accounts of subsequent years. They may have consequences in the prior years by reason of adjustments in net operating loss or unused excess profits credit carry-backs, and in intervening and subsequent taxable years by reason of adjustments in carry-overs. Adjustments are to be made for the several years affected consistent with the adjustments made for the year of liquidation. Detailed records shall be maintained such as will enable the Commissioner, in his examination of the taxpayer's returns for the year of replacement, readily to verify the extent of the inventory decrease claimed to be involuntary in character and the facts upon which such claim is based, all subsequent inventory increases and decreases, and all other facts material to the replacement adjustment authorized.

(g) Notwithstanding the ultimate purchase price or the cost of production ultimately incurred by the taxpayer in effecting replacement of a stock involuntarily liquidated, the merchandise reflecting the replacement shall be taken into purchases and included in the closing inventory for the year of replacement, and shall be included in the inventories of subsequent taxable years, at the inventory cost figure of the merchandise replaced.

(h) The goods reflected in any inventory increase in a year subsequent to a year of involuntary liquidation, to the extent that they constitute items of the kind and description liquidated in prior years, whether or not in a year of involuntary liquidation, shall be deemed, in the order of their acquisition, as having been acquired by the taxpayer in replacement of like goods most recently liquidated and not previously replaced; however, in a case involving involuntary liquidations of goods of the same class subject to the provisions of both section 22 (d) (6) (A) and section 22 (d) (6) (F) the involuntary liquidations of such goods subject to the provisions of section 22 (d) (6) (F) shall, for the purpose of replacements made in taxable years ending before January 1, 1953, be considered as having occurred prior to the involuntary liquidations of such goods subject to the provisions of section 22 (d) (6) (A) To the extent that the items of increase are allocated to items liquidated voluntarily, no adjustment will be required or permitted. Such replacement merchandise will be carried in the inventory at its actual cost of acquisition. To the extent that replacements are allocated to items involuntarily liquidated, however, the provisions of this section shall apply, both with respect to adjustments for the year of liquidation and other taxable years affected and with respect to inventory computations for the year of replacement and all subsequent taxable years.

(i) In some cases it may appear that, at the time of the filing of the income tax return for the year of replacement, or within three years thereafter, an adjustment with respect to the income or excess profits taxes for the year of the involuntary liquidation, or for some prior, intervening, or subsequent taxable year, is prevented by the running of the statute of limitations, by the execution of a closing agreement, by virtue of a court decision which has become final, or by reason of some other provision or rule of law other than section 3761 (relating to compromises) and other than the inventory replacement provisions. The adjustments provided for in connection with the involuntary liquidation and replacement of inventory shall nevertheless be made, but only if, within a period of three years after the date of the filing of the income tax return for the year of replacement, a notice of deficiency is mailed or a claim for refund is filed. No credit or refund will be allowed under such circumstances, whether within or without such three-year period, in the absence of a claim for refund duly filed; nor will a resulting deficiency be assessed or collected under section 272 (d) relating to waivers of restrictions. The issuance of the statutory notice of deficiency or the filing of a claim for refund are statutory conditions upon which depend the provisions of section 22 (d) (6) (E) The adjustment authorized by section 22 (d) (6) (E) is limited further to the tax attributable solely to the replacement adjustments. The amount of the adjustment shall be computed by reference to the amount of the tax previously determined, and without regard to factors affecting the taxable year involved to which no effect was given in such prior determination. The tax previously determined shall be ascertained in accordance with the principles stated in sections 452 (d) and 734 (d) § 40.452-4 of Regulations 130 (Part 40 of this chapter) and § 35.734-4 of Regulations 112 (26 CFR, 1943 Cum. Supp., Part 35) Any deficiency paid or any overpayment credited or refunded under these circumstances shall not be subject to recovery on a claim for refund or a suit for the recovery of an erroneous refund in any case in which such claim or suit is based upon factors other than those giving rise to the adjustments made.

§ 39.22 (e)-(k) *Statutory provisions; cross references; alimony, etc., income.*

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.

(j) *Income from mortgages made or obligations issued by joint stock land banks.* For taxable status of income derived from mortgages made or obligations issued by joint stock land banks, see section 3799.

(k) *Alimony, etc., income.* In the case of a wife who is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, periodic payments (whether or not made at regular intervals) received subsequent to such decree in discharge of, or attributable to property transferred (in trust or otherwise) in discharge of, a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by such husband under such decree or under a written instrument incident to such divorce or separation shall be includible in the gross income of such wife, and such amounts received as are attributable to property so transferred shall not be includible in the gross income of such husband. This subsection shall not apply to that part of any such periodic payment which the terms of the decree or written instrument fix, in terms of an amount of money or a portion of the payment, as a sum which is payable for the support of minor children of such husband. In case any such periodic payment is less than the amount specified in the decree or written instrument, for the purpose of applying the preceding sentence, such payment, to the extent of such sum payable for such support, shall be considered a payment for such support. Installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree or instrument shall not be considered periodic payments for the purposes of this subsection; except that an installment payment shall be considered a periodic payment for the purposes of this subsection if such principal sum, by the terms of the decree or instrument, may be or is to be paid within a period ending more than 10 years from the date of such decree or instrument, but only to the extent that such installment payment for the taxable year of the wife (or if more than one such installment payment for such taxable year is received during such taxable year, the aggregate of such installment payments) does not exceed 10 per centum of such principal sum. For the purposes of the preceding sentence, the portion of a payment of the principal sum which is allocable to a period after the taxable year of the wife in which it is received shall be considered an installment payment for the taxable year in which it is received. (In cases where such periodic payments are attributable to property of an estate or property held in trust, see section 171 (b).)

[Sec. 22 (k) as added by sec. 120 (a), Rev. Act 1942]

§ 39.22 (k)-1 *Alimony and separate maintenance payments; income to former wife*—(a) *In general.* (1) Section 22 (k) provides rules for treatment in certain cases of payments in the nature of or in lieu of alimony or an allowance for support as between spouses who are divorced or legally separated under a court order or decree. For convenience, the payee spouse will hereafter in this section be referred to as the "wife" and the spouse from whom she is divorced or legally separated as the "husband." See section 3797 (a) (17)

(2) Section 22 (k) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her after the decree of divorce or of separate

maintenance. Such periodic payments may be received from either of the two following sources:

(i) In discharge of a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by the husband, or

(ii) Attributable to property transferred (in trust or otherwise) in discharge of a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by the husband.

(3) The obligation of the husband must be imposed upon him or assumed by him (or made specific) under either of the following:

(i) A court order or decree divorcing or legally separating the husband and wife, or

(ii) A written instrument incident to such divorce or legal separation.

The periodic payments received by the wife attributable to property so transferred and includible in her income are not to be included in the gross income of the husband. See also § 39.171-1 in cases where such periodic payments are attributable to property held in trust.

(4) The purpose and effect of section 22 (k) may be illustrated, in general, by the following examples, in which it is assumed that the husband and wife make their income tax returns on the calendar year basis:

Example (1). W sues H for divorce in 1952. The court awards W temporary alimony of $25 a week pending the final decree. On September 1, 1952, the court grants W a divorce and awards her $200 a month permanent alimony. No part of the $25 a week temporary alimony received prior to the decree is includible in W's income under section 22 (k), but the $200 a month received during the balance of 1952 by W is includible in her income for 1952. Under section 23 (u), H is entitled to deduct such $200 payments from his income.

Example (2). W files suit for divorce from H. In consideration of W's promise to relinquish all marital rights and not to make public H's financial affairs, H makes a legally binding promise in writing to W to pay to her $200 a month if a final decree of divorce is granted without any provision for alimony. Accordingly, W does not request alimony and no provision for alimony is made under a final decree of divorce. During 1952, H pays W $200 a month, pursuant to the promise. The $2,400 thus received by W is includible in her gross income under the provisions of section 22 (k). Under section 23 (u), H is entitled to a deduction of $2,400 from his gross income.

Example (3). H and W enter into an antenuptial agreement, under which, in consideration of W's relinquishment of all marital rights (including dower) in H's property, and, in order to provide for W's support and household expenses, H promises to pay W $200 a month for her life. Ten years after their marriage, W sues H for divorce but does not ask for or obtain alimony because of the provision already made for her support in the antenuptial agreement. Likewise, the divorce decree is silent as to such agreement and H's obligation to support W. Section 22 (k) does not apply to such a case. If, however, the decree were modified so as to refer to the antenuptial agreement, or if, at the time of the divorce, reference had been made to the antenuptial agreement in the court's decree or in a written instrument incident to the divorce, section 22 (k) would require the inclusion of the payments received by W after the decree in her income. (As to including such payments in the wife's income, if made by a trust created under the antenuptial agreement, regardless of whether referred to in the decree or a later instrument, see § 39.171-1.)

(5) Section 22 (k) applies only where the legal obligation being discharged arises out of the family or marital relationship in recognition of the general obligation to support, which is made specific by the instrument or decree. Thus, section 22 (k) does not apply to that part of any periodic payment which is attributable to the repayment by the husband of, for example, a bona fide loan previously made to him by the wife, the satisfaction of which is specified in the divorce decree as a part of the general settlement between the husband and wife.

(6) Periodic payments are includible in the wife's income under section 22 (k) only for the taxable year in which received by her. As to such amounts, the wife is to be treated as if she makes her income tax returns on the cash receipts and disbursements basis, regardless of whether she normally makes such returns on the accrual basis. However, if the periodic payments described in section 22 (k) are to be made by an estate or trust, such periodic payments are to be included in the wife's taxable year in which they are includible according to the rules as to income of estates and trusts provided in sections 162, 164, and 171 (b) whether or not such payments are made out of the income of such estates or trusts.

(b) *Alimony income attributable to property.* (1) The full amount of periodic payments received under the circumstances described in section 22 (k) is required to be included in the gross income of the recipient whether such amounts are derived, in whole or in part, from income received or accrued by the source to which such payments are attributable. Thus, it matters not that such payments are attributable to property in trust, to life insurance, endowment, or annuity contracts, or to any other interest in property, or are paid directly or indirectly by the obligor husband from his income or capital. For example, if in order to meet an alimony obligation of $500 a month, the husband purchases or assigns for the benefit of his former wife a commercial annuity contract paying such amount, the full $500 a month received by the wife is includible in her income, and no part of such amount is includible in the husband's income or deductible by him. See section 22 (b) (2) (A) and § 39.22 (b) (2)-4. Likewise, if property is transferred by the husband, subject to an annual charge of $5,000, payable to his former wife in discharge of his alimony obligation under the divorce decree, the $5,000 received annually is, under section 22 (k) includible in the wife's income, regardless of whether such amount is paid out of income or principal of the property.

(2) The same rule applies to periodic payments attributable to property in trust. The full amount of periodic payments to which section 22 (k) applies is includible in the wife's income, regardless of whether such payments are made out of trust income. Such periodic payments are to be included in the wife's income under section 22 (k) and are to be excluded from the husband's income, even though the income of the trust would otherwise be includible in his income under section 22 (a), section 166, section 167, or any other section of the Code or the regulations in this part. As to periodic payments received by a former wife attributable to property in trust in cases to which section 22 (k) does not apply because the husband's obligation is not specified in the decree or an instrument incident thereto, see section 171 (a) and §39.171-1.

(3) Section 22 (k) does not apply to that part of any periodic payment attributable to that portion of any interest in property transferred in discharge of the husband's obligation under the decree or instrument incident thereto which interest originally belonged to the wife. It will apply, however, if she received such interest from her husband in contemplation of or as an incident to the divorce or separation without adequate and full consideration in money or money's worth, other than the release of the husband or his property from marital obligations. An example of the first rule is a case where the husband and wife transfer securities, which were owned by them jointly in trust to pay an annuity to the wife. In this case, the full amount of that part of the annuity received by the wife in discharge of the husband's obligation under the decree, or instrument incident thereto, is taxable to her under section 22 (k), while that portion of the annuity attributable to the wife's interest in the securities so transferred is taxable to her only to the extent it is out of trust income as provided in section 162. If, however, the husband's transfer of an interest in his property to his wife, preliminary to a transfer of such property in discharge of his obligation, is made in an attempt to avoid the application of section 22 (k) to part of such payments received by his wife, such transfers will be considered as a part of the same transfer by the husband of his property in discharge of his obligation. In such a case, section 22 (k) will be applied to the full amount received by the wife. As to periodic payments received under a joint purchase of a commercial annuity contract, see § 39.22 (b) (2)-4.

(c) *Alimony installment payments.* (1) In general, installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property specified in the decree of divorce or legal separation, or in an instrument incident thereto, are not considered "periodic payments" and therefore are not to be included under section 22 (k) in the wife's income. An exception to this general rule is provided, however, in cases where such principal sum, by the terms of the decree or such instrument, may be or is to be paid within a period ending more than 10 years from the date of such decree or instrument. In such cases, the installment payment is considered a periodic

payment for the purposes of section 22 (k) but only to the extent that the installment payment, or sum of the installment payments, received during the wife's taxable year does not exceed 10 percent of the principal sum. This 10 percent limitation applies to installment payments made in advance but does not apply to delinquent installment payments for a prior taxable year of the wife made during her taxable year.

(2) The rule as to installment payments may be illustrated by the following examples:

Example (1). Under the terms of a divorce decree, H is to pay W a gross sum of $100,000 in four annual installments. No part of the $100,000 is includible in W's income under section 22 (k) nor deductible by H.

Example (2). A divorce decree in 1952 provides that H is to pay W $20,000 each year for the next five years, beginning with the date of the decree, and then $5,000 each year for the next ten years. Assuming the wife makes her returns on the calendar year basis, each payment received in the years 1952–1956, inclusive, is a periodic payment under section 22 (k), but only to the extent of 10 percent of the principal sum of $150,000. Thus for such taxable years, only $15,000 of the $20,000 received is includible under section 22 (k) in the wife's income and is deductible by the husband under section 23 (u). For the years 1957–1966, inclusive, the full $5,000 received each year by the wife is includible in her income and is deductible from the husband's income.

Example (3). Under the terms of a separation agreement incident to divorce granted in December 1951, H agrees to pay W $500 on the first day of each month, beginning with the month after the decree, for 12 years. W makes her income tax returns on the calendar year basis while H makes his returns on the basis of the fiscal year ending June 30. H makes the promised payments in 1952 and, in addition, on December 31, 1952, pays W $1,500 as an advance payment of installments for the next three months. In the calendar year 1953, H makes no payments at all because of financial straits. On January 1, 1954, H inherits $15,000, which he immediately pays to W in satisfaction of not only his back alimony installments for the last nine months of 1953 but also his alimony installments for the next 21 months. The results as to H and W are as follows:

As to W: In the calendar year 1952, W received $7,500. Since 10 percent of $72,000 (the principal sum) is $7,200, only $7,200 of the $7,500 so received is includible in her income for 1952. For 1953 nothing is includible in her income under section 22 (k). In 1954, W received $15,000. Of this amount $4,500 is in payment of back installments and, therefore, is includible without limitation in her income for 1954. Of the balance of $10,500, only $7,200 is includible in her income for 1954.

As to H: For the taxable year ended June 30, 1952, H paid $3,000, all of which is deductible by H. In the taxable year ended June 30, 1953, H paid W $4,500, which, not being in excess of 10 percent of the principal sum, is deductible for such year. In his taxable year ended June 30, 1954, H paid $15,000, of which $11,700 (the sum of $4,500 and $7,200) is deductible.

(d) *Payments for support of minor children.* Section 22 (k) does not apply to that part of any periodic payment which, by the terms of the decree or the written instrument under section 22 (k) is specifically designated as a sum payable for the support of minor children of the husband. The statute prescribes the treatment in cases where an amount or portion is so fixed but the amount of any periodic payment is less than the amount of the periodic payment specified to be made. In such cases, to the extent of the amount which would be payable for the support of such children out of the originally specified periodic payment, such periodic payment is considered a payment for such support. For example, if the husband is by terms of the decree required to pay $200 a month to his divorced wife, $100 of which is designated by the decree to be for the support of their minor children, and the husband pays only $150 to his wife, $100 is nevertheless considered to be a payment by the husband for the support of the children. If, however, the periodic payments are received by the wife for the support and maintenance of herself and of minor children of the husband without such specific designation of the portion for the support of such children, then the whole of such amounts is includible in the income of the wife as provided in section 22 (k). Except in cases of a designated amount or portion for the support of the husband's minor children, periodic payments described in section 22 (k) received by the wife for herself and any other person or persons are includible in whole in the wife's income, whether or not the amount or portion for such other person or persons is designated.

§ 39.22 (l)–(m) *Statutory provisions; cross reference; services of child.*

SEC. 22. *Gross income.* * * *

(l) *Income of decedents.* For inclusion in gross income of certain amounts which constituted gross income in respect of a decedent, see section 126.

[Sec. 22 (l) as added by sec. 134 (c), Rev. Act 1942]

(m) *Services of child.* (1) Amounts received in respect of the services of a child shall be included in his gross income and not in the gross income of the parent, even though such amounts are not received by the child.

(2) All expenditures by the parent or the child attributable to amounts which are includible in the gross income of the child and not of the parent solely by reason of paragraph (1) shall be deemed to have been paid or incurred by the child.

(3) For the purposes of this subsection, the term "parent" includes an individual who is entitled to the services of a child by reason of having parental rights and duties in respect of the child.

(4) Any tax assessed against the child, to the extent attributable to amounts includible in the gross income of the child and not of the parent solely by reason of paragraph (1), shall, if not paid by the child, for all purposes be considered as having also been properly assessed against the parent.

[Sec. 22 (m) as added by sec. 7, Individual Income Tax Act 1944]

§ 39.22 (m)–1 *Services of child.* (a) Compensation for personal services of a child shall, regardless of the provisions of State law relating to who is entitled to the earnings of the child, and regardless of whether the income is in fact received by the child, be deemed to be the gross income of the child and not the gross income of the parent of the child. Such compensation, therefore, shall be included in the gross income of the child and shall be reflected in the return rendered by or for such child if the gross income for the taxable year amounts to $600 or more. The income of a minor child is not required to be included in the gross income of the parent for income tax purposes. For requirements for making the return by such child, or for such child by his guardian, or other person charged with the care of his person or property, see § 39.51–3. Any tax assessed against the child, to the extent of the amount attributable to income included in the gross income of the child solely by reason of section 22 (m) (1), if not paid by the child, shall, for the purposes of all provisions of law relating to the assesment and collection of the tax imposed by chapter 1, be considered as having also been properly assessed against the parent. In any case in which the earnings of the child are included in the gross income of the child solely by reason of section 22 (m) (1) the parent's liability is an amount equal to the amount by which the tax assessed against the child (and not paid by him) has been increased by reason of the inclusion of such earnings in the gross income of the child. Thus, if for 1952 the child has income of $1,000 from investments and of $3,000 for services rendered, and the latter amount is includible in gross income of the child under section 22 (m) (1) and the child has no wife or dependents, the tax liability determined under Supplement T is $696. If the child had only the investment income of $1,000, his tax liability would be $69. If the tax of $696 is assessed against the child, the difference between $696 and $69, or $627, is the amount of such tax which is considered to have been properly assessed against the parent.

(b) In the determination of net income or adjusted gross income, as the case may be, all expenditures made by the parent or the child attributable to amounts which are includible in the gross income of the child and not of the parent solely by reason of section 22 (m) (1) are deemed to have been paid and incurred by the child. In such determination, the child is entitled to take deductions not only for expenditures made on his behalf by his parent which would be commonly considered as business expenses, but also for other expenditures such as charitable contributions made by the parent in the name of the child and out of the child's earnings.

(c) For the purposes of section 22 (m) the term "parent" includes any individual who is entitled to the services of the child by reason of having parental rights and duties in respect of the child.

§ 39.22 (n) *Statutory provisions; adjusted gross income.*

SEC. 22. *Gross income.* * * *

(n) *Definition of "adjusted gross income"* As used in this chapter the term "adjusted gross income" means the gross income minus—

(1) *Trade and business deductions.* The deductions allowed by section 23 which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee;

(2) *Expenses of travel and lodging in connection with employment.* The deductions allowed by section 23 which consist of expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee;

(3) *Reimbursed expenses in connection with employment.* The deductions allowed by section 23 (other than expenses of travel, meals, and lodging while away from home) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer;

(4) *Deductions attributable to rents and royalties.* The deductions (other than those provided in paragraph (1), (5), or (6)) allowed by section 23 which are attributable to property held for the production of rents or royalties;

(5) *Certain deductions of life tenants and income beneficiaries of property.* The deductions (other than those provided in paragraph (1)) for depreciation and depletion, allowed by section 23 (l) and (m) to a life tenant of property or to an income beneficiary of property held in trust;

(6) *Losses from sales or exchange of property.* The deductions (other than those provided in paragraph (1)) allowed by section 23 as losses from the sale or exchange of property; and

(7) *Long-term capital gains.* The deduction allowed by section 23 (ee).

[Sec. 22 (n) as added by sec. 8 (a), Individual Income Tax Act 1944; amended by sec. 322 (c), Rev. Act 1951]

§ 39.22 (n)-1 *Adjusted gross income.* (a) The term "adjusted gross income" means the gross income computed under section 22 minus such of the deductions allowable under section 23 as are specified in section 22 (n) Adjusted gross income is used as the basis for the determination of the following: The tax under Supplement T; the amount of the standard deduction; the amount of the deduction for charitable contributions under section 23 (o) and the amount of the deduction for medical and dental expenses under section 23 (x)

(b) Section 22 (n) does not create any new deductions, but merely specifies which of the deductions provided in section 23 shall be allowed in computing adjusted gross income. The circumstance that a particular item is specified in one of the clauses under section 22 (n) and is also embraced within the terms of another of such clauses does not permit the item to be twice deducted in computing adjusted gross income.

(c) The deductions specified in section 22 (n) for the purpose of computing adjusted gross income are: (1) Deductions allowable under section 23, which are attributable to a trade or business carried on by the taxpayer not consisting of services performed as an employee; (2) deductions allowable by section 23 which constitute expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee; (3) deductions allowable by section 23 (other than expenses of travel, meals, and lodging while away from home) which consist of expenses paid or incurred in connection with the performance of services as an employe under a reimbursement or other expense-allowance arrangement with his employer; (4) deductions allowable under section 23 which are attributable to rents and royalties; (5) deductions for depreciation and depletion allowable under section 23 (l) and (m) to a life tenant of property or to an income beneficiary of property held in trust; (6) deductions which are allowable under section 23 as losses from the sale or exchange of property and (7) the deductions for long-term capital gains allowed by sections 23 (ee) and 117 (b)

(d) For the purpose of the deductions specified in section 22 (n) the performance of personal services as an employee does not constitute the carrying on of a trade or business. The practice of a profession, not as an employee, is considered the conduct of a trade or business within the meaning of such section. To be deductible for the purposes of determining adjusted gross income, expenses must be those directly, and not those merely remotely, connected with the conduct of the trade or business. For example, taxes are deductible in arriving at adjusted gross income only if they constitute expenditures directly attributable to the trade or business or to property from which rents or royalties are derived. Thus, property taxes paid or incurred on real property used in the trade or business are deductible but State income taxes are not deductible even though the taxpayer's income is derived from the conduct of a trade or business.

(e) Traveling expenses paid or incurred by an employee in connection with his employment while away from home which are deductible from gross income in computing net income may be deducted from gross income in computing adjusted gross income. Among the items included in traveling expenses are charges for transportation of persons or baggage, expenditures for meals and lodging, and payments for the use of sample rooms for the display of goods. See § 39.23 (a)-2.

(f) Expenses, other than traveling expenses, paid or incurred by an employee which are deductible from gross income in computing net income and for which he is reimbursed by the employer under an express agreement for reimbursement or pursuant to an expense allowance arrangement may also be deducted from gross income in computing adjusted gross income.

§ 39.22 (o) *Statutory provisions; gross income; dealers in short-term municipal bonds.*

SEC. 22. *Gross income.* * * *

(o) *Dealers in tax-exempt securities*—(1) *Adjustment for bond premium.* In computing the gross income of a taxpayer who holds during the taxable year a short-term municipal bond (as defined in paragraph (2) (A)) primarily for sale to customers in the ordinary course of his trade or business—

(A) If the gross income of the taxpayer from such trade or business is computed by the use of inventories and his inventories are valued on any basis other than cost, the cost of securities sold (as defined in paragraph (2) (B)) during such year shall be reduced by an amount equal to the amortizable bond premium that would be disallowed as a deduction for such year pursuant to section 125 (a) (2) if the definition in section 125 (d) of the term "bond" did not exclude such short-term municipal bond; or

(B) If the gross income of the taxpayer from such trade or business is computed without the use of inventories, or by use of inventories valued at cost, and the short-term municipal bond is sold or otherwise disposed of during such year, the adjusted basis (computed without regard to this subparagraph) of the short-term municipal bond shall be reduced by the amount of the adjustment that would be required under section 113 (b) (1) (H) if the definition in section 125 (d) of the term "bond" did not exclude such short-term municipal bond.

(2) *Definitions.* For the purposes of paragraph (1)—

(A) The term "short-term municipal bond" means any obligation issued by a government or political subdivision thereof if the interest on such obligation is excludible from gross income; but such term does not include such an obligation if (i) it is sold or otherwise disposed of by the taxpayer within thirty days after the date of its acquisition by him, or (ii) its earliest maturity or call date is a date more than five years from the date on which it was acquired by the taxpayer.

(B) The term "cost of securities sold" means the amount ascertained by subtracting the inventory value of the closing inventory of a taxable year from the sum of (i) the inventory value of the opening inventory for such year and (ii) the cost of securities and other property purchased during such year which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

[Sec. 22 (o) as added by sec. 203 (a), Rev. Act 1950]

§ 39.22 (o)-1 *Treatment of bond premiums in case of dealers in tax-exempt securities*—(a) *In general.* (1) Section 22 (o) requires certain adjustments to be made by dealers in securities with respect to premiums paid on short-term municipal bonds which are held for sale to customers in the ordinary course of the trade or business. The adjustments depend upon the method of accounting used by the taxpayer in computing the gross income from the trade or business. See paragraphs (b) and (c) of this section.

(2) The term "short-term municipal bond" under section 22 (o) means any obligation issued by a government or political subdivision thereof if the interest on the obligation is excludable from gross income under section 22 (b) (4) Such term, however, does not include an obligation the maturity or earliest call date of which is a date more than five years from the date of acquisition by the taxpayer, or an obligation sold or otherwise disposed of by the taxpayer within 30 days after the date of acquisition by him. A bond which is otherwise within the definition of "short-term municipal bond" is subject to the provisions of section 22 (o) if held by the taxpayer for a period of more than 30 days, whether or not such period is entirely within one taxable year.

(b) *Inventories not valued at cost.* (1) In the case of a dealer in securities who

computes gross income from his trade or business by the use of inventories and values such inventories on any basis other than cost, the adjustment required by section 22 (o) is the reduction of "cost of securities sold" by the amount equal to the amortizable bond premium which would be disallowed as a deduction under section 125 (a) (2) if the dealer were an ordinary investor holding such bond. Such amortizable bond premium is computed under section 125 (b) by reference to the cost or other original basis of the bond on the date of acquisition (determined without regard to section 113 (a) (1) relating to inventory value on a subsequent date) If the date of acquisition precedes July 1, 1950, then, in computing under section 125 (b) the amount of such amortizable bond premium, there shall be made adjustments to bond premium proper to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 117 (h)) prior to the date as of which section 22 (o) first becomes applicable to the bond in the hands of the taxpayer. See § 39.125 (b)-1.

(2) Subparagraph (1) may be illustrated by the following example:

Example. X, a dealer in securities who values his inventories on a basis other than cost, makes his income tax returns on the calendar year basis. On January 1, 1949, he bought, for $1,060 each, three short-term municipal bonds (A, B, and C) having a face obligation of $1,000, and maturing on January 1, 1954. On July 1, 1952, he buys, for $1,018 each, three more bonds (X, Y, and Z) of the same issue. Bonds A and X are sold on December 31, 1952. Bonds B and Y are sold on June 30, 1953. Bonds C and Z are sold on December 31, 1953. The adjustment for the years 1952 and 1953 is as follows:

Bond	Date acquired	Date sold	Adjustment for—	
			1952	1953
A	Jan. 1, 1949	Dec. 31, 1952	$12.00	------
B	do	June 30, 1953	12.00	$6.00
C	do	Dec. 31, 1953	12.00	12.00
X	July 1, 1952	Dec. 31, 1952	6.00	------
Y	do	June 30, 1953	6.00	6.00
Z	do	Dec. 31, 1953	6.00	12.00
Total			54.00	36.00

For the purpose of determining such adjustment, the amortizable bond premium is computed under section 125 (b) as follows:

	Bond A, B, or C	Bond X, Y, or Z
Bond premium	$60.00	$18.00
Adjustment for period prior to first date of application of sec. 22 (o):		
Applicable Jan. 1, 1951	24.00	------
Amortizable bond premium to maturity	[1] 36.00	[2] 18.00
Amortizable bond premium per month	1.00	1.00

[1] Jan. 1, 1951, to Jan. 1, 1954.
[2] July 1, 1952, to Jan. 1, 1954.

(3) The term "cost of securities sold" means the amount ascertained by subtracting the inventory value of the closing inventory of a taxable year from the sum of the inventory value of the opening inventory for such year and the cost of securities and other property purchased during such year which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

(c) *Inventories not used or inventories valued at cost.* (1) In the case of a dealer in securities who computes gross income from his trade or business without the use of inventories or by use of inventories valued at cost, the adjustment required by section 22 (o) is a reduction of the adjusted basis of each short-term municipal bond sold or otherwise disposed of during the taxable year. The amount of such reduction is the amount by which the adjusted basis of such bond would be required to be reduced under section 113 (b) (1) (H) were such bond subject to the amortizable bond premium provisions of section 125, that is, the amount of the amortizable bond premium which would be disallowed as a deduction under section 125 (a) (2) if the taxpayer were an ordinary investor.

(2) If the bond was acquired before July 1, 1950, the amount of the reduction shall not include the amount of such amortizable bond premium which would be disallowed as a deduction under section 125 (a) (2) if the taxpayer were an ordinary investor, for any taxable year beginning before July 1, 1950. In the case of such bond, the amortizable bond premium which would be disallowed as a deduction under section 125 (a) (2) is determined after making adjustments to bond premium proper to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 117 (h)) prior to the date as of which section 22 (o) first becomes applicable to the bond in the hands of the taxpayer. See § 39.125 (b)-1.

(3) The application of subparagraph (2) may be illustrated by the following example:

Example. Y, a dealer in securities who values his inventories on the basis of cost, makes his income tax returns on the calendar year basis. On January 1, 1949, he buys, for $1,060 each, three short-term municipal bonds (D, E, and F) having a face obligation of $1,000, and maturing on January 1, 1954. On July 1, 1952, he buys, for $1,018 each, three more bonds (U, V, and W) of the same issue. Bonds D and U are sold on December 31, 1952. Bonds E and V are sold on June 30, 1953. Bonds F and W are sold on December 31, 1953.

Bond	Date acquired	Date sold	Adjustment for—	
			1952	1953
D	Jan. 1, 1949	Dec. 31, 1952	$24.00	------
E	do	June 30, 1953	None	$30.00
F	do	Dec. 31, 1953	None	36.00
U	July 1, 1952	Dec. 31, 1952	6.00	------
V	do	June 30, 1953	None	12.00
W	do	Dec. 31, 1953	None	18.00

For the purpose of determining such adjustments, the amortizable bond premium is computed under section 125 (b) as follows:

	Bond D, E, or F	Bond U, V, or W
Bond premium	$60.00	$18.00
Adjustment for period prior to first date of application of sec. 22 (o):		
Applicable Jan. 1, 1951	24.00	------
Amortizable bond premium to maturity	[1] 36.00	[2] 18.00
Amortizable bond premium per month	1.00	1.00

[1] Jan. 1, 1951, to Jan. 1, 1954.
[2] July 1, 1952, to Jan. 1, 1954.

§ 39.23 (a) *Statutory provisions; deductions from gross income; expenses.*

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

(a) *Expenses*—(1) *Trade or business expenses*—(A) *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. In the case of any sports program conducted for the benefit of the American National Red Cross, expenses described in section 22 (b) (16) (B) shall be allowable under this subparagraph only to the extent that such expenses exceed the amount excluded from gross income by section 22 (b) (16).

(B) *Corporate charitable contributions.* No deduction shall be allowable under subparagraph (A) 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.

(C) *Expenditures for advertising and good will.* If a corporation has, for the purpose of computing its excess profits credit under Chapter 2E, or subchapter D of this Chapter, claimed the benefits of the election provided in section 733 or section 451, as the case may be, no deduction shall be allowable under subparagraph (A) to such corporation for expenditures for advertising or the promotion of good will which, under the rules and regulations prescribed under section 733 or section 451, as the case may be, may be regarded as capital investments.

(2) *Non-trade or non-business expenses.* In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

[Sec. 23 (a) as amended by sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 121 (a), Rev. Act 1942; sec. 303, Excess Profits Tax Act 1950; sec. 2, Pub. Law 465 (82d Cong.)]

[Legislative Branch Appropriation Act, 1953.]

* * * for the two taxable years beginning after December 31, 1952, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered to be his home for the purposes of section 23 (a) (1) (A) of the Internal Revenue Code, but amounts expended by such Member within

each such taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

[Pub. Law 471 (82d Cong.)]

§ 39.23 (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 items which are used as the basis for a deduction or a credit under provisions of law other than subsection (a) of section 23. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code cannot again be deducted under any other provision thereof. As to charitable contributions by corporations not deductible under section 23 (a) see § 39.23 (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 § 39.22 (a)-5. Among the items included in business expenses are management expenses, commissions (but see § 39.24 (a)-2), 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 § 39.23 (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. No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other 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. As to the deductibility of expenditures attributable to a grant or loan made to a taxpayer by the United States for the encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, see section 22 (b) (15) and § 39.22 (b) (15)-1.

§ 39.23 (a)-2 *Traveling expenses.* (a) 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.

(b) 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.

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

(d) 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.

(e) A payment for the use of a sample room at a hotel for the display of goods is a business expense.

(f) Only such expenses as are reasonable and necessary in the conduct of the business and directly attributable to it may be deducted.

(g) A taxpayer claiming the benefit of the deductions referred to in this section 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.

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

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

§ 39.23 (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.

§ 39.23 (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 cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, 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.

§ 39.23 (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.

§ 39.23 (a)-6 *Compensation for personal services.* (a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business 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.

(b) The test set forth in paragraph (a) of this section 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. 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 stockholdings 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. 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.

§ 39.23 (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.

§ 39.23 (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.

§ 39.23 (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)

§ 39.23 (a)-10 *Rentals.* (a) 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.

(b) 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. In cases in which the lease contains an unexercised option of renewal, the matter of spreading such depreciation or amortization over the term of the original lease, together with the renewal period or periods, depends upon the facts in the particular case. As a general rule, unless the lease has been renewed or the facts show with reasonable certainty that the lease will be renewed, the cost or other basis of the lease or the cost of improvements shall be spread only over the number of years the lease has to run, without taking into account any right of renewal.

§ 39.23 (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 livestock 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 § 39.41-2) 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 § 39.22 (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 §§ 39.22 (a)-7, 39.23 (e)-5, and 39.23 (l)-10.)

§ 39.23 (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.

§ 39.23 (a)-13 *Corporate contributions.* (a) 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.

(b) The limitations provided in section 23 (a) (1) and this section 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.

§ 39.23 (a)-14 *Expenditures for advertising or promotion of good will.* A corporation which has, for the purpose of computing its excess profits credit, elected under section 451 (applicable to the excess profits tax imposed by subchapter D of chapter 1) to charge to capital account for taxable years in its base period expenditures for advertising or the promotion of good will which may be regarded as capital investments may not deduct similar expenditures for the taxable year. Such a taxpayer has the burden of proving that expenditures for advertising or the promotion of good will which it seeks to deduct for such later taxable years may not be regarded as capital investments under the provisions of the regulations prescribed under section 451. For rules for determining what expenditures for advertising or the promotion of good will may be regarded as capital investments, and for information required to be submitted with respect to such expenditures, see § 40.451-2 of Regulations 130 (Part 40 of this chapter) (applicable to the excess profits tax imposed under subchapter D of chapter 1)

§ 39.23 (a)-15 *Nontrade or nonbusiness expenses.* (a) Subject to the qualifications and limitations in chapter 1 and particularly in section 24, an expense may be deducted under section 23 (a) (2) only upon the condition that:

(1) It has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and

(2) It is an ordinary and necessary expense for either or both of the purposes stated in subparagraph (1) of this paragraph.

(b) The term "income" for the purpose of section 23 (a) (2) comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter incurred in connection therewith are deductible. Similarly, ordinary and necessary expenses incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses incurred in managing, conserving, or maintaining property held for investment may be deductible under this provision even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto. The expenses, however, of carrying on transactions, which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses.

(c) Expenses, to be deductible under section 23 (a) (2) must be "ordinary and necessary" which presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(d) Except for the requirement of being incurred in connection with a trade or business, a deduction under this section is subject to all the restrictions and limitations that apply in the case of the deduction under section 23 (a) (1) (A) of an expense paid or incurred in carrying on any trade or business. This includes restrictions and limitations contained in section 24. Section 24 (a) (5) disallows any amount otherwise allowable as a deduction (whether under section 23 (a) (2) or otherwise) which is allocable to one or more classes of tax-exempt income, other than interest, and, in addition, disallows a deduction under section 23 (a) (2) for amounts otherwise allowable under that section which are allocable to tax-exempt interest. Thus, any amount allocable to the production or collection of one or more classes of income which is not includible in gross income or to the management, conservation, or maintenance of property held for the production of such income is not deductible under section 23 (a) (2) Nor does section 23 (a) (2) allow any expenses which are disallowed by any of the provisions of chapter 1.

(e) Capital expenditures, and expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case, including the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer.

(f) Among expenditures not allowable under section 23 (a) (2) are the following: Commuter's expenses; expenses of taking special courses or training; expenses for improving personal appearance; the cost of rental of a safe-deposit box for storing jewelry and other personal effects; and expenses such as expenses in seeking employment or in placing oneself in a position to begin rendering personal services for compensation, campaign expenses of a candidate for public office, bar examination fees and other expenses incurred in securing admission to the bar, and corresponding fees and expenses incurred by physicians, dentists, accountants, and other taxpayers for securing the right to practice their respective professions.

(g) Fees for services of investment counsel, custodian fees, clerical help, office rent, and similar expenses paid or incurred by a taxpayer in connection with investments held by him are deductible under section 23 (a) (2) only if (1) they are paid or incurred by the taxpayer for the production or collection of income, or for the management, conservation, or maintenance of investments held by him for the production of income; and (2) they are ordinary and necessary under all the circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment.

(h) Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible

even though such property was formerly held by the taxpayer for use as a home.

(i) Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under this section, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see § 39.162-1 for disallowance of such deductions to an estate where such items are claimed as a deduction under section 812 (b) in computing the net estate subject to the estate tax.

(j) Reasonable amounts paid or incurred for the services of a guardian or committee for a ward or minor, and other expenses of guardians and committees which are ordinary and necessary in connection with the production or collection of income inuring to the ward or minor, or in connection with the management, conservation, or maintenance of property, held for the production of income, belonging to the ward or minor, are deductible.

(k) Expenditures incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in income) or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenditures incurred in protecting or asserting one's rights to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible. Expenses paid or incurred by an individual in the determination of liability for taxes upon his income are deductible. If property is held by an individual for the production of income, amounts expended in determining a property tax imposed with respect to such property during the period when so held are deductible. Expenses paid or incurred by an individual in determining or contesting any liability asserted against him do not become deductible, however, by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability. Thus, expenses paid or incurred by an individual in the determination of gift tax liability, except to the extent that such expenses are allocable to interest on a refund of gift taxes, are not deductible, even though property held by him for the production of income must be sold to satisfy an assessment for such tax liability or even though, in the event of a claim for refund, the amount received will be held by him for the production of income.

(l) The deduction of an item otherwise allowable under section 23 (a) (2) will not be disallowed simply because the taxpayer also had an election under chapter 1 to treat it as a capital expenditure, rather than to deduct it as an expense. (See section 24 (a) (7).) Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in chapter 1, no deduction is allowable under this section; and this is true regardless of whether any basis adjustment is allowed under section 113.

(m) The provisions of section 23 (a) (2) are not intended in any way to disallow expenses which would otherwise be allowable under section 23 (a) (1) or the regulations applicable thereto, or under any other section of the Internal Revenue Code or the regulations applicable thereto. Double deductions are not permitted. Amounts deducted under one provision of the Code cannot again be deducted under any other provision thereof.

§ 39.23 (b) *Statutory provisions; deductions from gross income; interest.*

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 chapter.

§ 39.23 (b)-1 *Interest.* (a) 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 (1) obligations of the United States issued after September 24, 1917, the interest upon which is not wholly exempt from the taxes imposed by chapter 1, or (2) (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 chapter 1, is deductible in accordance with the general rule.

(b) 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 of Maryland or Pennsylvania ground rents are deductible as interest if the ground rent is redeemable, but are treated as rent if the ground rent is irredeemable and in such case are deductible only to the extent they constitute a proper business expense.

(c) 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, 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).

§ 39.23 (c) *Statutory provisions; deductions from gross income; taxes.*

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

(c) *Taxes generally*—(1) *Allowance in general.* Taxes paid or accrued within the taxable year, except—

(A) Federal income taxes;

(B) War-profits and excess-profits taxes imposed by Title II of the Revenue Act of 1917, Title III of the Revenue Act of 1918, Title III of the Revenue Act of 1921, section 216 of the National Industrial Recovery Act, or section 702 of the Revenue Act of 1934, or Subchapter E of Chapter 2, or by any such provisions as amended or supplemented;

(C) Income, war-profits, and excess-profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 131;

(D) Estate, inheritance, legacy, succession, and gift taxes;

(E) 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; and

(F) Federal import duties, and Federal excise and stamp taxes (not described in subparagraph (A), (B), (D), or (E)), but this subsection shall not prevent such duties and taxes from being deducted under subsection (a).

(2) [Repealed by sec. 105 (c) (2), Rev. Act 1942.]

(3) *Gasoline and retail sales taxes.* In the case of a tax imposed by any State, Territory, District, or possession of the United States, or any political subdivision thereof, upon persons engaged in selling tangible personal property at retail, or upon persons selling gasoline or other motor vehicle fuels either at wholesale or retail, which is measured by the gross sales price or the gross receipts from the sale or which is a stated sum per unit of such property sold, or upon persons engaged in furnishing services at retail, which is measured by the gross receipts for furnishing such services, if the amount of such tax is separately stated, then to the extent that the amount so stated is paid by the consumer (otherwise than in connection with the consumer's trade or business) to his vendor such amount shall be allowed as a deduction in computing the net income of such consumer as if such amount constituted a

tax imposed upon and paid by such consumer.

[Sec. 23 (c) as amended by sec. 506 (b), Second Rev. Act 1940; sec. 202 (a), Rev. Act 1941; secs. 105 (c) (1) (2), 122, 158 (b), Rev. Act 1942; sec. 111, Rev. Act 1943; Pub. Law 29 (82d Cong.)]

§ 39.23 (c)–1 *Taxes*—(a) *In general.* Subject to the exceptions stated in this section and §§ 39.23 (c)–2 and 39.23 (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, the employment taxes imposed by sections 1400, 1500, and 1510, and Federal income taxes (including the tax withheld at source under section 1622) are not deductible from gross income. The Federal war-profits and excess-profits taxes imposed by Title II of the Revenue Act of 1917, Title III of the Revenue Act of 1918, Title III of the Revenue Act of 1921, section 216 of the National Industrial Recovery Act, section 702 of the Revenue Act of 1934, and subchapter E of chapter 2 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 choose to take to any extent for the taxable year the benefits of section 131 (relating to credit for taxes of foreign countries or possessions of the United States) See the last sentence of section 131 (a) 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)

(b) *State and local sales and gasoline taxes.* (1) Amounts representing sales or gasoline taxes paid by a consumer of services or tangible personal property are deductible by such consumer as taxes, provided they are not paid in connection with his trade or business. The fact that, under the law imposing it, the incidence of the sales or gasoline tax does not fall on the consumer is immaterial. The requirement of section 23 (c) (3) that the amount of the tax must be separately stated will be deemed complied with where it clearly appears that, at the time of sale to the consumer, the tax was added to the sales price and collected or charged as a separate item. It is not necessary, for the purposes of this section, that the consumer be furnished with a sales slip, bill, invoice, or other statement on which the tax is separately stated. Where the law imposing the sales or gasoline tax for which the taxpayer seeks a deduction contains a prohibition against the seller absorbing the tax, or a provision requiring a posted notice stating that the tax will be added to the quoted price, or a requirement that the tax be separately shown in advertisements or separately stated on all bills and invoices, it is presumed that the amount of the sales or gasoline tax was separately stated at the time paid by the consumer; except that such presumption shall have no application to a gasoline tax imposed upon a wholesaler unless such provisions of law apply with respect to both the sale at wholesale and the sale at retail.

(2) As used in this section the term "sales tax" means a tax imposed by any State, Territory, District, or possession of the United States, or any political subdivision thereof upon persons engaged in selling tangible personal property at retail, which is measured by the gross sales price or the gross receipts from the sale, or which is a stated sum per unit of such property sold. The term also includes a tax imposed by such authorities upon persons engaged in furnishing services at retail, which is measured by the gross receipts for furnishing such services.

(3) The term "gasoline tax" means, for the purpose of this section, a tax imposed by such authorities upon persons selling gasoline or other motor vehicle fuels either at wholesale or retail, which is measured by the gross sales price or the gross receipts from the sale, or which is a stated sum per unit of the gasoline or fuel sold.

(4) In general, the term "consumer" means the ultimate user or purchaser; it does not include a purchaser who acquires the property for resale, such as a retailer.

§ 39.23 (c)–2 *Federal duties and excise taxes.* Federal import or tariff duties, business, license, privilege, excise, and stamp taxes (not described in subparagraph (A) (B) (D) or (E) of section 23 (c) (1)) paid or accrued within the taxable year are not deductible as taxes. The fact that any such tax is not deductible as a tax under section 23 (c) does not prevent (a) a deduction therefor under section 23 (a) provided it represents an ordinary and necessary expense paid or incurred during the taxable year by a corporation or an individual in carrying on any trade or business, or, in the case of an individual, for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income, or (b) the inclusion of such tax paid or incurred during the taxable year by a corporation or an individual as a part of the cost of acquisition or production in the trade or business, or, in the case of an individual, as a part of the cost of property held for the production of income with respect to which such tax is paid or incurred.

§ 39.23 (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.

§ 39.23 (d) *Statutory provisions; deductions from gross income; taxes of shareholder paid by corporation.*

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

(d) *Taxes of shareholder 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.

§ 39.23 (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 Internal Revenue Code 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.

§ 39.23 (e) *Statutory provisions; deductions from gross income; losses by individuals.*

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.

§ 39.23 (e)-1 *Losses by individuals.* (a) Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (1) incurred in the taxpayer's trade or business, or (2) incurred in any transaction entered into for profit, or (3) 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 (4) if not prohibited or limited by any of the following sections of the Internal Revenue Code: 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 the United States; and section 252, relating to citizens of possessions of the United States. See sections 211, 213, and 220 as to limitation upon losses sustained by nonresident aliens.

(b) 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) For special provisions with respect to war losses, see section 127.

(c) 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.

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

(e) 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 1940 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, 1949. From that date to January 1, 1952, 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, 1949, was $22,000, of which $12,000 was allocable to the building. The building had an estimated life of 20 years on January 1, 1949. The property was sold on January 1, 1952, 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 1940	$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, 1949	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 1940	$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

§ 39.23 (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.

§ 39.23 (e)-3 *Loss of useful value.* (a) When, through some change in business conditions, the usefulness in the business of some or all of the 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 §§ 39.113 (a) (14)-1 and 39.113 (b) (1)-1 to 39.113 (b) (4)-1, inclusive) 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. 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.

(b) 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.

(c) 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 §§ 39.113 (a) (14)-1 and 39.113 (b) (1)-1 to 39.113 (b) (4)-1, inclusive) and its salvage value and/or amount realized upon its

disposition may be allowed subject to the limitations provided in the Internal Revenue Code upon deductions for losses, but only if it is clearly evident that such disposition was not contemplated in the rate of depreciation.

(d) 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 §§ 39.113 (a) (14)-1 and 39.113 (b) (1)-1 to 39.113 (b) (4)-1, inclusive) less its salvage value is allowable upon its retirement.

§ 39.23 (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 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 § 39.22 (c)-5. For limitations on deductions for losses from sales or exchanges of capital assets generally including stocks and bonds, see section 117.

§ 39.23 (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 livestock has been purchased 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 livestock, less any depreciation allowable as a deduction in respect of such perished livestock, 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 livestock 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 livestock 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 § 39.23 (e)-1. See also §§ 39.22 (a)-7, 39.23 (a)-11, and 39.23 (l)-10.

§ 39.23 (f) *Statutory provisions; deductions from gross income; losses by corporations.*

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.

§ 39.23 (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 §§ 39.23 (e)-1 to 39.23 (e)-5, inclusive, and §39.23 (i)-1 are in general applicable to corporations as well as individuals. See section 232 as to deductions by foreign corporations. For special provisions with respect to war losses, see section 127.

§ 39.23 (g) *Statutory provisions; deductions from gross income; capital losses.*

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 chapter, 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 paragraph (2) of [this] subsection the term "securities" means (A) shares of stock in a corporation, and (B) rights to subscribe for or to receive such shares.

(4) *Stock in affiliated corporation.* For the purposes of paragraph (2) stock in a corporation affiliated with the taxpayer shall not be deemed a capital asset. For the purposes of this paragraph a corporation shall be deemed to be affiliated with the taxpayer only if:

(A) At least 95 per centum of each class of its stock is owned directly by the taxpayer; and

(B) More than 90 per centum of the aggregate of its gross incomes for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the company in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, or gains from sales or exchanges of stocks and securities; and

(C) The taxpayer is a domestic corporation.

[Sec. 23 (g) as amended by sec. 123 (a), Rev. Act 1942; sec. 112 (a), Rev. Act 1943]

§ 39.23 (g)-1 *Capital losses.* (a) Section 23 (g) provides 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 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, provided the securities are "capital assets" as that term is defined in section 117 (a) (1). 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. Section 23 (g) does not apply to securities which are deemed destroyed or seized under section 127, relating to war losses.

(b) As used in section 23 (g) and this section, the term "securities" means shares of stock in a domestic or foreign corporation and rights to subscribe for or to receive such shares.

§ 39.23 (g)-2 *Loss on stock of affiliate.* (a) If a taxpayer is a domestic corporation and is affiliated, within the definition in section 23 (g) (4), with another corporation, the stock in such affiliated corporation owned by the taxpayer is not considered to be a "capital asset" of the taxpayer for the purpose of determining the loss from the worthlessness of such stock within the provisions of section 23 (g) (2) and § 39.23

(g)-1. For the purposes of section 23 (g) (2) section 23 (g) (4) § 39.23 (g)-1, and this section, a corporation shall be deemed to be affiliated with the taxpayer only if all the following factors are present:

(1) The taxpayer owns directly at least 95 percent of each class of the stock of such corporation,

(2) More than 90 percent of the aggregate of the gross incomes of such corporation for all the taxable years during which it has been in existence has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the company in the ordinary course of its operating business) dividends, interest (except interest received on deferred purchase price of operating assets sold) annuities, or gains from sales or exchanges of stocks and securities, and

(3) The taxpayer is a domestic corporation.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. Corporation P, a domestic manufacturing corporation which makes its income tax returns on the calendar year basis, owns 100 percent of each class of the stock of Corporation S, and, in addition, 4 percent of the common stock (the only class of stock) of Corporation R which it acquired in 1944. Corporation S, a domestic manufacturing corporation which makes its income tax returns on the calendar year basis, owns 96 percent of the common stock of Corporation R which it acquired in 1942. It is established that the stock of Corporation R which has from its inception derived all its gross income from manufacturing operations, became worthless during 1952. Since Corporation P does not own directly at least 95 percent of the stock of Corporation R, and therefore for the purposes of section 23 (g) (4) and this section is not affiliated with Corporation R, the stock of such corporation is a capital asset. Any loss upon such stock, under section 23 (g) (2), will be considered to be a loss from the sale or exchange of a capital asset. Since such stock was held for more than six months, such loss shall be considered a long-term capital loss under section 117. (See also section 117 (d).) Since Corporation R is deemed to be affiliated with Corporation S for the purposes of section 23 (g) (4) and this section, the stock of Corporation R is not a "capital asset" in the hands of Corporation S for the purposes of section 23 (g) (2) and § 39.23 (g)-1. Consequently, in computing the net income of Corporation S for 1952 any loss upon such stock, under section 23 (f), will be deducted as an ordinary loss and will not be circumscribed by the provisions of section 23 (g) or section 117.

(c) With respect to losses on bonds and similar securities, as defined in section 23 (k) (5) of a corporation affiliated with the taxpayer, as provided in such section, see § 39.23 (k)-4.

§ 39.23 (h) *Statutory provisions; deductions from gross income; wagering losses.*

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.

§ 39.23 (h)-1 *Wagering losses.* Deductions for losses from wagering transactions are allowed only to the extent of gains from such transactions. In the case of a husband and wife making a joint return, the combined losses of the spouses as a result of wagering transactions shall be allowed to the extent of the combined gains of the spouses from such transactions.

§ 39.23 (i) *Statutory provisions; deductions from gross income; basis for determining loss.*

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

(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.

§ 39.23 (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.

§ 39.23 (j)-(k) *Statutory provisions; deductions from gross income; cross reference; bad debts.*

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 which become worthless 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. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection. In the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit, the reasonable addition to a reserve for bad debts shall be determined with due regard to the amount of the taxpayer's surplus or bad debt reserves existing at the close of December 31, 1951. In the case of a taxpayer described in the preceding sentence, the reasonable addition to a reserve for bad debts for any taxable year shall in no case be less than the amount determined by the taxpayer as the reasonable addition for such year; except that the amount determined by the taxpayer under this sentence shall not be greater than the lesser of (A) the amount of its net income for the taxable year, computed without regard to this subsection, or (B) the amount by which 12 per centum of the total deposits or withdrawable accounts of its depositors at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year.

(2) *Securities becoming worthless.* If any securities (as defined in paragraph (3) of this subsection) become worthless 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 chapter, 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 paragraphs (1), (2), and (4) of 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.

(4) *Non-business debts.* In the case of a taxpayer, other than a corporation if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(5) *Securities of affiliated corporations.* Bonds, debentures, notes or certificates or other evidences of indebtedness issued with interest coupons or in registered form by any corporation affiliated with the taxpayer shall not be deemed capital assets for the purposes of paragraph (2) and paragraph (1) shall apply with respect to such debt except that no such deduction shall be allowed under such paragraph with respect to any such debt which is recoverable only in part. For the purposes of this paragraph a corporation shall be deemed to be affiliated with the taxpayer only if:

(A) At least 95 per centum of each class of its stock is owned directly by the taxpayer; and

(B) More than 90 per centum of the aggregate of its gross income for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the company in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, or gains from sales or exchanges of stocks and securities; and

(C) The taxpayer is a domestic corporation.

(6) *Exception.* This subsection shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to debts owed by (A) any political party, (B) any national, state, or local committee of any political party, or (C) any committee, association, or organization which accepts contributions or makes expenditures for the purpose of influencing or attempting to influence the election of Presidential or Vice Presidential electors or of any individual whose name is presented for election to any Federal, State, or local elective public office, whether or not such individual is elected. For the purpose of this paragraph, the terms "contributions" and "expenditure" shall have the meanings prescribed for such terms

in section 591 of title 18 of the United States Code.

[Sec 23 (k) as amended by sec. 124 (a), Rev. Act 1942; secs. 112 (b), 113, Rev. Act 1943; sec. 313 (e), Rev. Act 1951; Pub. Law 471 (82d Cong.)]

§ 39.23 (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 which become worthless in whole or in part, or

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

(b) Taxpayers were given a similar option for 1921 to select either of the methods mentioned for treating such debts. (See article 151, Regulations 62.) While ascertainment of worthlessness and charge-off during the taxable year (which were prerequisite to deduction of a bad debt under the law at that time) are no longer required for the allowance of a debt which becomes wholly worthless, the method used in the return for 1921 must be used in returns for all subsequent years 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 § 39.23 (k)-5.)

(c) If, from all the surrounding and attending circumstances, the Commissioner is satisfied that a debt is partially worthless, the amount which has become worthless, to the extent charged off during the taxable year, shall be allowed as a deduction in computing net income. If a taxpayer claims a deduction for a part of a debt for the taxable year within which such part of the debt is charged off and such deduction is disallowed for such year and the debt becomes partially worthless subsequent to such year, a deduction may be allowed for a subsequent taxable year, not in excess of the amount charged off in the prior year plus any amount charged off in the subsequent year, the charge-off in the prior year, if consistently maintained as such, being sufficient to that extent to meet the charge-off requirement. Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the Commissioner the amount thereof which is uncollectible and the part thereof which was charged off. If a debt becomes wholly worthless during the taxable year, the amount thereof which has not been allowed as a deduction for any prior taxable year shall be allowed as a deduction for the taxable year. There should accompany the return a statement of facts substantiating any deduction claimed for bad debts. Any amount subsequently received on account of a bad debt or on account of a part of such debt previously allowed as a deduction for income tax purposes must be included in gross income for the taxable year in which received, except to the extent excludible from gross income under the provisions of section 22 (b) (12) 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.

(d) 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. In bankruptcy cases a debt may become worthless before settlement in some instances, and in others only when a settlement in bankruptcy shall have been had. In either case 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.

(e) 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, to the extent charged off during the taxable year, be conclusively presumed, for income tax purposes, to have become worthless or worthless only in part during the taxable year, as the case may be. But no such debt shall be so conclusively presumed to be worthless or worthless only in part, as the case may be, if the amount so charged off is not claimed as a deduction by the taxpayer at the time of filing the return for the taxable year in which such charge-off takes place. If a taxpayer does not claim a deduction in its return for such a totally or partially worthless debt for the year in which such charge-off takes place, but claims such deduction for a later year, then such charge-off in the prior year will be deemed to have been involuntary and the deduction shall be allowed for the year for which claimed, if the taxpayer produces sufficient evidence to show (1) that the debt became wholly worthless in such later year or became recoverable only in part subsequent to the year of such involuntary charge-off, as the case may be, and (2) that, to the extent that the deduction claimed in the later year for a debt partially worthless was not involuntarily charged off in prior years, it was charged off in the later year.

(f) The provisions of paragraphs (a) to (d) inclusive, of this section apply generally to all taxpayers. However, they do not apply in the case of a taxpayer, other than a corporation, with respect to a nonbusiness debt as defined in section 23 (k) (4) Nor shall any deduction be allowed on account of the worthlessness of any debt of the type enumerated in section 23 (k) (5) which is recoverable only in part. In the case of taxpayers other than banks as defined in section 104, the term "debts" as used in paragraphs (a) to (d), inclusive, of this section means obligations to pay fixed or determinable sums of money which are not evidenced by securities as defined in § 39.23 (k)-4.

§ 39.23 (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 become worthless 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.

§ 39.23 (k)-3 *Uncollectible deficiency upon sale of mortgaged or pledged property.* (a) 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 portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, the mortgagee or pledgee 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 has become wholly worthless or is charged off as partially worthless. 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.

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

§ 39.23 (k)-4 *Worthless bonds and similar obligations.* (a) Except as otherwise provided in section 23 (k) (5) no deduction is allowable under section 23 (k) (1) to any taxpayer (other than a bank as defined in section 104) with respect to a debt evidenced by a security which has become worthless in whole or in part. If a security is a capital asset and becomes worthless during the taxable year, a deduction for the loss resulting therefrom is allowable under section 23 (k) (2) to a taxpayer other than a bank. 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 actually became worthless. Except in the case of a bank as defined in section 104, no deduction is allowable under section 23 (k) with respect to a debt evidenced by a security, as defined in section 23 (k) (3) which is recoverable only in part. Section 23 (k) (2) does not apply to securities which are deemed destroyed or seized under section 127, relating to war losses.

(b) As used in section 23 (k) (2) 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 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.

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

(d) 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, however, due, for instance, to the financial condition of the debtor, or conditions other than market fluctuation, the taxpayer 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 section) and he so demonstrates to the satisfaction of the Commissioner, and if he has made a proper charge-off with respect to the debt partially uncollectible, 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 section.

(e) Under section 23 (k) (5) bonds, debentures, notes or certificates, or other evidences of indebtedness to pay a fixed or determinable sum of money, issued with interest coupons or in registered form by any corporation affiliated with the taxpayer, shall not be deemed capital assets of the taxpayer for the purposes of section 23 (k) (2) or as a debt (evidenced by a security) for the purposes of this section; and the provisions of section 23 (k) (1) and of paragraphs (a) to (d) inclusive, of § 39.23 (k)-1 shall apply with respect to such debts except that no deduction shall be allowed to the taxpayer with respect to any such debt which is recoverable only in part. For the purposes of this section, a corporation is deemed to be affiliated with the taxpayer only if the taxpayer owns at least 95 percent of each class of the stock of such corporation, if more than 90 percent of the aggregate of the gross incomes of such corporation for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the company in the ordinary course of its operating business) dividends, interest (except interest received on deferred purchase price of operating assets sold) annuities, or gains from the sales or exchanges of stocks and securities, and if the taxpayer is a domestic corporation.

§ 39.23 (k)-5 *Reserve for bad debts*—(a) *Taxpayer other than mutual savings banks, building and loan associations, and cooperative banks.* (1) Taxpayers who have established the reserve method of treating bad debts and maintained proper reserve accounts for bad debts, or who, in accordance with § 39.23 (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.

(2) 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 become wholly or partially worthless and have been charged against the reserve account.

(b) *Mutual savings banks, building and loan associations, and cooperative banks*—(1) *In general.* A mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit may, as an alternative to a deduction from gross income for specific debts which become worthless in whole or in part, deduct amounts credited to a reserve for bad debts in the manner and under the circumstances prescribed in this section. In the case of such an institution the selection of either of the alternative methods for treating bad debts may be made by the taxpayer in the return for its first taxable year beginning after December 31, 1951. The method selected shall be subject to the approval of the Commissioner upon examination of the return. Any change in the method so selected and approved may be made only if permission is granted as provided in § 39.23 (k)-1 (b)

(2) *Definitions.* When used in this paragraph—

(i) The term "institution" means either a mutual savings bank not having capital stock represented by shares, a domestic building and loan association as defined in section 3797 (a) (19) or a cooperative bank without capital stock organized and operated for mutual purposes and without profit.

(ii) "Surplus, undivided profits, and reserves" means the amount by which the total assets of an institution exceed the amount of the total liabilities of such an institution. For this purpose the term "total assets" means the sum of money, plus the aggregate of the adjusted basis of the property other than money held by an institution. Such adjusted basis for any asset is its adjusted basis for determining gain upon sale or exchange for Federal income tax purposes. (See, in general, section 113 and the regulations prescribed thereunder. For special rules with respect to adjustments to basis for prior taxable years during which the institution was exempt from tax, see § 39.113 (b) (1)-4.) The determination of the total assets of any taxpayer shall conform to the method of accounting employed by such taxpayer in determining net income and to the rules applicable in determining its earnings and profits. The term "total liabilities" means all liabilities of the taxpayer, which are fixed and determined, absolute and not contingent, and includes those items which constitute liabilities in the sense of debts or obligations. The total deposits or withdrawable accounts, as defined in subdivision (iv) of this subparagraph, shall be considered a liability. In the case of a building and loan association having permanent nonwithdrawable capital stock represented by shares, the paid-in amount of such stock shall also be considered a liability. Reserves for con-

tingencies and other reserves, however, which are mere appropriations of surplus are not liabilities.

(iii) The term "surplus or bad debt reserves existing at the close of December 31, 1951" means the amount of surplus, undivided profits, and reserves accumulated by the institution prior to January 1, 1952, and in existence at the close of December 31, 1951.

(iv) The term "total deposits or withdrawable accounts" means the aggregate of (*a*) amounts placed with an institution for deposit or investment and (*b*) earnings outstanding on the books of account of the institution at the close of the taxable year which have been credited as dividends upon such accounts prior to the close of the taxable year, except that in the case of a building and loan association, such term does not include permanent nonwithdrawable capital stock represented by shares, or earnings credited thereon.

(3) *Institutions with surplus, reserves, and undivided profits in an amount less than 12 percent of total deposits or withdrawable accounts.* Where 12 percent of the total deposits or withdrawable accounts of an institution at the close of the taxable year exceeds the sum of its surplus, undivided profits, and reserves at the bginning of the taxable year, there is allowable as a deduction from gross income as an addition to a reserve for bad debts any amount determined by the taxpayer not exceeding the lesser of:

(i) The amount of the net income of such institution for the taxable year computed without regard to section 23 (k) (1) or,

(ii) The amount by which 12 percent of the total deposits or withdrawable accounts at the close of the taxable year exceeds the sum of the institution's surplus, undivided profits, and reserves at the beginning of the taxable year.

Bad debt losses sustained during the taxable year shall be charged against the bad debt reserve. Recoveries of debts charged against the bad debt reserve during a prior taxable year in which the institution was subject to tax under this chapter shall be credited to the bad debt reserve. The establishment of such reserve and all adjustments made thereto must be reflected on the regular books of account of the institution at the close of the taxable year, or as soon as practicable thereafter. For the purpose of this paragraph minimum amounts credited in compliance with Federal or State statutes, regulations, or supervisory orders, to reserve or similar accounts, or additional amounts credited to such reserve or similar accounts and permissive under such statutes, regulations, or orders, against which charges may be made for the purpose of absorbing losses sustained by an institution will be deemed to have been credited to the bad debt reserve authorized under this paragraph.

Example (1). On January 1, 1952, and on December 31, 1952, Institution A, which keeps its books on the basis of the calendar year, has total deposits or withdrawable accounts of $10,000,000, all of which amount is insured by an agency of the Federal government. The surplus, reserves, and undivided profits of Institution A at the opening of business on January 1, 1952, total $800,000. A regulation of a Federal agency requires that at the close of the taxable year an amount equal to 0.3 percent of the value of the insured accounts at the beginning of the year be credited by Institution A to a Federal insurance reserve for the sole purpose of absorbing losses. A statute of the State having jurisdiction over Institution A requires that not less than 5 percent of the net profits of Institution A, computed before provisions for dividends, be credited at the close of the year to a "reserve fund" for the purpose of absorbing losses. The credit to such reserve fund of additional amounts in excess of 5 percent of net profits is permissive under such statute, provided that the total amounts credited do not exceed 25 percent of net profits. It is assumed for the purpose of determining the amount to be credited to the State reserve fund that "not less than 5 percent of the net profits" of Institution A, computed under State law before provisions for dividends for the taxable year 1952 amounts to $17,500.

Prior to the taxable year Institution A did not maintain a reserve for bad debts. During 1952 Institution A sustained bad debt losses of $5,000. The net income of Institution A for the taxable year 1952, computed under chapter 1 after taking into account all applicable deductions (including the deduction for dividends provided in section 23 (r) (1)) except the deduction provided in section 23 (k) (1) is $200,000.

The books of account of Institution A show credits for the taxable year 1952 to the following reserves:

Federal insurance reserve	$30,000
State reserve fund	25,000
Bad debt reserve	45,000
Miscellaneous reserves	15,000

There is allowable as a deduction under section 23 (k) (1) $100,000 ($45,000 credited to the bad debt reserve, $30,000 credited to the Federal insurance reserve, and $25,000 representing a permissive amount less than 25 percent of net profits under the State statute, credited to the State reserve fund).

Assuming that Federal income taxes for 1952 amount to $46,500 on the net income of $100,000, the amount credited to the surplus account for 1952 will be $38,500, that is, $53,500 ($100,000 minus $46,500) less the $15,000 credited to miscellaneous reserves for which no bad debt deduction is allowable. Consequently, the surplus, undivided profits, and reserves of Institution A, amounting to $800,000 at the close of December 31, 1951, as increased by amounts credited to these accounts for 1952 will total $948,500 at the close of December 31, 1952, computed as follows:

Surplus, reserves, and undivided profits at close of Dec. 31, 1951		$800,000
Amount credited to miscellaneous reserve accounts for 1952		15,000
Amount credited to State reserve fund for 1952		25,000
Amount credited to Federal insurance reserve for 1952		30,000
Amount credited to surplus for 1952		38,500
Bad debt reserve at close of Dec. 31, 1951		0
Amount credited to reserve for bad debts for 1952	$45,000	
Less: Bad debt losses sustained during 1952	5,000	
Bad debt reserve at close of Dec. 31, 1952		40,000
Surplus, undivided profits and reserves existing at close of Dec. 31, 1952		948,500

Example (2). The net income of Institution B for the taxable year 1952, computed under chapter 1 after all deductions including the deduction for dividends, but before the deduction provided in section 23 (k) (1), is determined to be $250,000. Such $250,000 is credited by Institution B to the bad debt reserve as provided in secton 23 (k) (1) and § 39.23 (k)-5 (b) (3). The amount by which 12 percent of the total deposits or withdrawable accounts of Institution B at the close of the taxable year exceeds the sum of such institution's surplus, undivided profits and reserves at the beginning of the taxable year is $500,000.

During 1954, upon examination of the return of income filed by Institution B for 1952, it is determined that the net income of such institution, properly computed, without regard to section 23 (k) (1) is $275,000. Assuming that Institution B credits the additional $25,000 to its bad debt reserve, there is allowable as a deduction from gross income for such institution for the taxable year 1952, $275,000.

(4) *Institutions with surplus, reserves, and undivided profits equal to or in excess of 12 percent of deposits or withdrawable accounts.* Where 12 percent of the total deposits or withdrawable accounts of an institution at the close of the taxable year is equal to or less than the sum of such institution's surplus, undivided profits and reserves at the beginning of the taxable year, there may be allowable as a deduction from gross income a reasonable addition to the reserve for bad debts determined under the general provisions of paragraph (a) of this section. In making such determination there will be taken into account (i) surplus, or bad debt reserves existing at the close of December 31, 1951, and (ii) changes in the surplus, undivided profits, and reserves of the institution from December 31, 1951, until the beginning of the taxable year. Deductions for additions to the reserve for bad debts, in addition to the deductions allowed, if any, under subparagraph (3) of this paragraph, will be authorized in those cases where the institution proves to the satisfaction of the Commissioner that the bad debt experience of the institution warrants the maintenance of a bad debt reserve in excess of that provided in subparagraph (3) of this paragraph.

§ 39.23 (k)-6 *Nonbusiness bad debts.* (a) In the case of a taxpayer, other than a corporation, if a nonbusiness bad debt becomes entirely worthless within the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange of a capital asset held for not more than six months. Such a loss is subject to the limitations provided in section 117 with respect to gains and losses from the sale and exchange of capital assets. A loss with respect to such a debt will be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a nonbusiness debt which is recoverable in part during the taxable year. Nor are the provisions of this section applicable in the case of a loss resulting from a security as defined in section 23 (k) (3) A nonbusiness debt is a debt, other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business

and other than a debt evidenced by a security as that term is defined in section 23 (k) (3) The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23 (e) is "incurred in trade or business" under section 23 (e) (1)

(b) The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a nonbusiness debt for the purposes of this section.

(c) To illustrate: A, an individual engaged in the grocery business and who makes his income tax returns on the calendar year basis, extends credit on an open account to B in 1951.

(1) In 1952 A sells the business but retains the claim against B. The claim becomes worthless in A's hands in 1953. A's loss is controlled by the nonbusiness debt provisions. While the original consideration was advanced by A in his trade or business, the loss was not sustained as a proximate incident to the conduct of any trade or business in which he was engaged at the time the claim became worthless.

(2) In 1952 A sells the business to C but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1953, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the nonbusiness debt provisions, even though the original consideration was advanced by A in his trade or business.

(3) In 1952 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands in 1953. C's loss is not controlled by the nonbusiness debt provisions. While C did not advance any consideration for the claim or acquire it in carrying on his trade or business, the loss was sustained as a proximate incident to the conduct of the trade or business in which he was engaged at the time the debt became worthless.

(4) In 1952 A dies, leaving the business to his son, C, but the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1953, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the nonbusiness debt provisions, even though the original consideration was advanced by A in his trade or business.

(5) In 1952 A dies and while his executor, C, is carrying on the business, the claim against B becomes worthless in 1952. The loss sustained by A's estate is not controlled by the nonbusiness debt provisions. While C did not advance any consideration for the claim on behalf of the estate or acquire it in carrying on a trade or business in which the estate was engaged, the loss was sustained as a proximate incident to the conduct of the trade or business in which the estate was engaged at the time the debt became worthless.

(6) In 1952, A, in liquidating the business, attempts to collect the claim against B but finds that it has become worthless. A's loss is not controlled by the nonbusiness debt provisions, since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

§ 39.23 (l) *Statutory provisions; deductions from gross income; depreciation.*

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 (including a reasonable allowance for obsolescence)—

(1) Of property used in the trade or business, or

(2) Of property held for the production of income.

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.

[Sec. 23 (l) as amended by sec. 121 (c), Rev. Act 1942]

§ 39.23 (l)-1 *Depreciation.* A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, or treated under § 39.23 (a)-15 as held by the taxpayer for the production of income, 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 is that amount which should be set aside for the taxable year in accordance with a reasonably 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 depreciable property, 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. For deduction with respect to the amortization of emergency facilities, in lieu of the deduction for depreciation, see sections 23 (t) and 124A.

§ 39.23 (l)-2 *Depreciable property.* The necessity for a depreciation allowance arises from the fact that certain property used in the business, or treated under § 39.23 (a)-15 as held by the taxpayer for the production of income, 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 Internal Revenue Code. (See sections 23 (m) and 114.) Property kept in repair may, nevertheless, be the subject of a depreciation allowance. (See § 39.23 (a)-4.) The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business, or treated under § 39.23 (a)-15 as held by the taxpayer for the production of income. 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.

§ 39.23 (l)-3 *Depreciation of intangible property.* Intangibles, the use of

which in the trade or business or in the production of income 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 or in the production of income 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 or in the production of income 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.

§ 39.23 (l)-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. 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.

§ 39.23 (l)-5 *Method of computing depreciation allowance.* (a) 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.

(b) 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 provision may be illustrated by the following example:

Example. An asset was purchased January 1, 1947, 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 1947 to 1951 as follows:

1947	$500
1948	-----
1949	1,000
1950	1,000
1951	1,000
Total amount allowed	3,500

The correct reserve as of December 31, 1951, is computed as follows:

Dec. 31—	
1947 ($10,000−10)	$1,000
1948 ($9,000−9)	1,000
1949 ($8,000−8)	1,000
1950 ($7,000−7)	1,000
1951 ($6,000−6)	1,000
Reserve Dec. 31, 1951	5,000

Depreciation for 1952 is computed as follows:

Cost	$10,000
Reserve as of December 31, 1951	5,000
Unrecovered cost	5,000
Depreciation allowable for 1952 ($5,000—5)	1,000

§ 39.23 (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.

§ 39.23 (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. 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.

§ 39.23 (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.

§ 39.23 (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 ac-

count, 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.

§ 39.23 (l)-10 *Depreciation in 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 livestock acquired for work, breeding, or dairy purposes, unless they are included in an inventory used to determine profits in accordance with § 39.22 (a)-7. Such depreciation should be based on the cost or other basis and the estimated life of the livestock. If such livestock 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 §§ 39.23 (a)-11 and 39.23 (e)-5.)

§ 39.23 (m) *Statutory provisions; deductions from gross income; depletion.*

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 deductions 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).

§ 39.23 (m)-1 *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.* (a) 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.

(b) Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. However, no depletion deduction shall be allowed the owner with respect to any timber or coal which such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber or coal, if such disposal is considered a sale of timber or coal under section 117 (k) (2) An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

(c) The adjusted basis of depreciable property is returnable through annual depreciation deductions. Depreciation and depletion deductions on the property of a corporation are allowed to the corporation and not to its shareholders. 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 § 39.23 (l)-1.)

(d) When used in §§ 39.23 (m)-1 to 39.23 (m)-19, inclusive—

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

(2) 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.

(3) The term "mineral deposit" refers to minerals in place. 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.

(4) The term "minerals" includes ores of the metals, coal, oil, gas, and such nonmetallic substances as abrasives, asbestos, asphaltum, barite, bauxite, bentonite, beryl, borax, building stone, cement rock, china clay, clay, crushed stone, feldspar, fluorspar, fuller's earth, gilsonite, graphite, gravel, gypsum, lepidolite, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, pyrophyllite, refractories, rock phosphate, salt, sand, silica, slate, soapstone, soda, spodumene, sulfur, talc, thenardite, trona, and vermiculite.

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

(e) As used in sections 114 (b) (3) and 114 (b) (4) (A) and §§ 39.23 (m)-1 to 39.23 (m)-19, inclusive, the term "gross income from the property" means the following:

(1) In the case of oil and gas wells, "gross income from the property," as used in section 114 (b) (3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. If the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, or are transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation.

(2) In the case of a crude mineral product other than oil and gas, "gross income from the property," as used in section 114 (b) (4) (A) means the gross income from mining. The term "mining" as used herein includes not only the extraction of ores or minerals from the ground but also the ordinary treatment processes which are normally applied by the mine owners or operators to the crude mineral product after extraction in order to obtain the commercially marketable mineral product or products. The term "mining" as used herein also includes so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles, and, if the Commissioner finds that both the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills, the transportation over such greater distance. The taxpayer shall file an original and one copy of an application for the inclusion of such greater distance in the computation of his gross income from mining with the Commissioner of Internal Revenue, Washington 25, D. C., attention of the Special Technical Services Division, Engineering and Valuation Branch. The application must include

a statement setting forth in detail such facts concerning the physical and other requirements for the construction and operation of a treatment plant at a place nearer to the point of extraction from the ground as are sufficient to apprise the Commissioner of the exact basis of the application. If the taxpayer's return is filed prior to receipt of notice of the Commissioner's action upon the application, a copy of such application shall be attached to the return. If, after an application is approved by the Commissioner, there is a material change in any of the facts relied upon in such application, a new application must be submitted by the taxpayer.

(3) If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold; but, if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product (other than transportation treated, for the taxable year, as mining) 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 (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

(4) In case any of the ordinary treatment processes are not applied in the immediate vicinity of the mining district in which the mine is located, costs incurred for transportation to the processing location and, if transported by the taxpayer, the proportionate profits attributable to transportation, should be subtracted from the sale price of the product to determine "gross income from the property." In determining "gross income from the property" the sale price of the product shall not be reduced by the costs and proportionate profits attributable to the transportation which is treated for such taxable year as mining, that is, so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles (or, if the Commissioner finds that both the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills, such greater distance) Where such plants or mills are in excess of 50 miles (or of such greater distance) from the point of extraction from the ground, then costs incurred for transportation in excess of 50 miles (or of such greater distance) to the treatment plant and, if transported by the taxpayer, the proportionate profits attributable to such excess transportation should be subtracted from the sale price of the product to determine "gross income from the property" In the absence of methods which will clearly reflect costs of the various phases of transportation, the costs attributable to such excess transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation to the treatment plant as the transportation included within the term "mining" is to such total transportation. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation other than the computation of profits proportionate to cost clearly reflects the gross income from the property then such gross income shall be computed by the use of such other method.

(5) 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 have been paid in respect of the property in the taxable year or any prior years, or if advanced royalties have been paid in respect of the property in any taxable year ending prior to December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the product sold during the current taxable year. If advanced royalties have been paid in respect of the property in any taxable year ending on or after December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to the deduction for such taxable year taken on account of such payments pursuant to § 39.23 (m)-10 (e)

(6) Rents and royalties paid or incurred by a taxpayer with respect to coal shall be excluded from the "gross income from the property" without regard to the treatment under section 117 (k) (2) of such rents and royalties in the hands of the recipient.

(f) (1) The term "ordinary treatment processes," as used in §§ 39.23 (m)-1 to 39.23 (m)-19, inclusive, shall include the following:

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

(ii) In the case of sulfur—pumping to vats, cooling, breaking, and loading for shipment;

(iii) In the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, and sintering (agglomerating by incipient fusion) to bring to shipping grade and form, and loading for shipment;

(iv) In the case of lead, zinc, copper, gold, silver, or fluorspar ores, potash, and minerals which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic) cyanidation, leaching, crystallization, precipitation, or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the mineral. The furnacing of quicksilver ores is included in the term "ordinary treatment processes." The following processes are not included in the term "ordinary treatment processes": electrolytic deposition, roasting, thermal or electric smelting, refining, or substantially equivalent processes.

(2) In addition, a treatment effecting a chemical change, the blending with other material, a thermal action, and the fine pulverization, pressing into shape or molding, are not included in the term "ordinary treatment processes" unless such processes are (i) otherwise provided for in subdivisions (i), (ii), (iii), or (iv) of subparagraph (1) (ii) necessary or incidental to the processes provided for in subdivisions (i), (ii), (iii), or (iv) of subparagraph (1), or (iii) necessary to bring the ores or minerals into condition or form suitable for shipment (for example, the agglomeration of concentrates)

(3) For the purposes of subdivisions (iii) and (iv) of subparagraph (1) the terms "concentration" or "concentrating" mean the process of eliminating waste or of separating two or more minerals or ores.

(g) "Net income of the taxpayer (computed without allowance for depletion) from the property," as used in section 114 (b) (2) (3) and (4) and §§ 39.23 (m)-1 to 39.23 (m)-19, inclusive, means the "gross income from the property," as defined in paragraph (e) of this section, 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 (f) of this section in so far as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense or allowable as deductions under section 23 (cc) 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 (f) of this

section, 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 (f) of this section 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 (f) of this section 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 (f) of this section shall, in turn, be fairly apportioned to the several properties, taking into account their relative production.

(h) As used in paragraphs (e) and (f) of this section, the term "crude mineral product" means the product in the form in which it emerges from the mine or well.

(i) "The property," as used in section 114 (b) (2) (3) and (4) and §§ 39.23 (m)-1 to 39.23 (m)-19, inclusive, means the interest owned by the taxpayer 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.

§ 39.23 (m)-2 *Computation of depletion of mines, oil and gas wells, and other natural deposits without reference to discovery value or percentage depletion.* (a) The basis upon which depletion, other than discovery depletion or percentage depletion, is to be alowed in respect of any property is the basis provided for 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, except that the amount of expenditures treated as deferred expenses under sections 23 (cc) (2) and 23 (ff) (2) shall be disregarded in determining such adjusted basis (see §§ 39.113 (a)-1 to 39.114-1, inclusive, and §§ 39.23 (cc)-1 and 39.23 (ff)-1) and 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.

(b) As used in this section, 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.

(c) "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 section.

(d) In determining the amount of the basis as adjusted applicable to the mineral deposit there shall be excluded (1) amounts representing the cost or value of the land for purposes other than mineral production, (2) the amount recoverable through depreciation, through deferred expenses, and through deductions other than depletion, and (3) 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 § 39.23 (m)-16, are recoverable through depletion.

(e) 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.

§ 39.23 (m)-3 *Computation of depletion of mines and other natural deposits (other than those in respect of which percentage depletion is allowable) on basis of discovery value.* (a) The basis on which depletion is to be computed in the case of mines and other natural deposits (other than those in respect of which depletion is allowed on the basis of percentage of income under § 39.23 (m)-5) 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 or deposits 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. Such basis may not be used in the case of the mines or deposits listed under § 39.23 (m)-5 for any period in respect to which depletion on the basis of percentage of income is allowable. The value must be equitably apportioned between the owners of the economic interests therein. For the method of determining whether a discovery has been made, see § 39.23 (m)-14. For the method of determining the fair market value, see § 39.23 (m)-7.

(b) 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.

(c) The depletion allowance based on discovery value under this section 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 § 39.23 (m)-1 (g)

(d) As used in this section, the phrase "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 section.

(e) As used in this section, 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.

§ 39.23 (m)-4 *Computation of depletion based on a percentage of income in 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 § 39.23 (m)-1 (e) and (g).) In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided in section 113.

§ 39.23 (m)-5 *Computation of depletion based on percentage of income in*

case of certain mines or other natural deposits. (a) In the case of the mines or other natural deposits listed hereinafter, a taxpayer may deduct for depletion under section 114 (b) (4) (A) amounts equal to the following percentages of the gross income from the property:

Mine or deposit:	Percent
Aplite	15
Asbestos	10
Barite	15
Bauxite	15
Bentonite	15
Beryl	15
Borax	15
Bromine	5
Brucite	10
Calcium carbonates	10
Calcium chloride	5
Clam shell	5
Clay:	
Ball	15
Brick and tile	5
China	15
Refractory and fire	15
Sagger	15
Coal	10
Diatomaceous earth	15
Dolomite	10
Feldspar	15
Fluorspar	15
Fullers earth	15
Garnet	15
Gilsonite	15
Granite	5
Graphite, flake	15
Gravel	5
Lepidolite	15
Limestone:	
Chemical grade	15
Metallurgical grade	15
Magnesite	10
Magnesium carbonates	10
Magnesium chloride	5
Marble	5
Metal mines	15
Mica	15
Oyster shells	5
Perlite	10
Phosphate rock	15
Potash	15
Pumice	5
Pyrophillite	15
Quartzite	15
Rock asphalt	15
Sand	5
Scoria	5
Shale	5
Slate	5
Sodium chloride	5
Spodumene	15
Stone	5
Sulfur	23
Talc	15
Thenardite	15
Tripoli	15
Trona	15
Vermiculite	15
Wollastonite	10

Such deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowances 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 § 39.23 (m)-1 (e) and (g).) In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided in section 113.

(b) For the purposes of this section, the minerals indicated below shall have the following meanings:

Borax	Any boron material including that contained in brines.
Bromine	Bromine if obtained from brine wells.
Calcium carbonates	Miscellaneous limestones and other calcium carbonate rocks (not specifically provided for at a 5 percent or 15 percent rate of percentage allowance) such as cement rock and limestone used or sold for use in soil treatment. This classification does not include rock or minerals used or sold for use as ballast, road making, concrete aggregates, or other purposes for which chemical composition is not a major requirement.
Calcium chloride	Calcium chloride if produced from brine wells.
Clay, brick and tile	Clay used or sold for use in the manufacture of common brick, drain and roofing tile, sewer pipe, flower pots and kindred products (other than clay specifically identified as a clay for which a 15 percent rate of percentage allowance is provided).
Coal	All coal including lignite.
Limestone, chemical grade	Limestone used or sold for use in the chemical trades.
Limestone, metallurgical grade	Limestone used or sold for use in the production of metals.
Magnesium chloride	Magnesium chlorides if produced from brine wells.
Phosphate rock	Any phosphate ore.
Pumice	All pumice including pumicite.
Scoria	All scoria produced from natural deposits.
Stone	All common dimension, crushed or broken stone within the ordinary meaning of these terms.
Thenardite	All sodium sulphate minerals, including those contained in brine.
Trona	All sodium carbonate minerals, including those contained in brine.

(c) A taxpayer may compute the depletion allowance provided in this section, or in § 39.23 (m)-2, without regard to any election previously made in respect of computation of the allowances.

(d) Percentage depletion is not allowable with respect to any disposal of coal to the extent that such disposal is treated as a sale of coal under section 117 (k) (2)

§ 39.23 (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 interest in any mineral property was acquired, the taxpayer will be required to show that the cost or price at which such interest was bought was fixed for the purpose of a bona fide purchase and sale, by which the interest 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 interest sold, due weight will be given to the relationship or connection existing between the person selling the interest and the buyer thereof.

§ 39.23 (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 a 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 expected profit, (2) the rate at which this profit will be obtained, and (3) the rate of interest commensurate with the risk for the particular de-

posit. In case of oil and gas properties the additional factors are (4) the total quantity of oil and gas in terms of the principal or customary unit (or units) paid for in the product marketed, (5) the quantity of oil and gas expected to be recovered during each operating period, (6) the average quality or grade of the oil and gas reserves, (7) the allocation of the total expected profit to the several processes or operations necessary for the preparation of the oil and gas for market, (8) the probable operating life of the deposit in years, (9) the development cost, and (10) the operating cost. In order to estimate the total expected profit from the operation of 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) of this section 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 § 39.23 (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 §§ 39.23 (m)-15 and 39.23 (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 § 39.23 (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 value of each mineral deposit is measured by the expected gross income (the number of units of mineral recoverable in marketable form multiplied by the estimated market price per unit) less the estimated operating cost, 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) If, for the purpose of the equitable apportionment of depletion among the several owners of economic interests, the value of any mineral property must be ascertained as of any specific date for the determination of the basis for depletion, the values of the several interests therein 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.

§ 39.23 (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 in respect to which depletion is not allowed on the basis of percentage of income under § 39.23 (m)-4 or § 39.23 (m)-5, 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 § 39.23 (m)-9, and

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

§ 39.23 (m)-9 *Determination of mineral contents of mines and of oil or gas wells.* (a) 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:

(1) 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

(2) "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 (i) 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 (ii) as to grade, only as accords with the best indications available as to richness.

(b) If the number of recoverable units of mineral in the property has 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 taxable year will be the number remaining from the prior estimate, but in any case in which it is ascertained either by the taxpayer or the Commissioner as the result of operations or development work prior to the close of the taxable year that the remaining recoverable mineral units as of the taxable year are materially greater or less than the number remaining from the

prior estimate, then the estimate of the remaining recoverable units shall be revised and the annual depletion allowance with respect to the property for the taxable year and for subsequent taxable years will be based upon the revised estimate unless a change in the facts requires another revision. Such revised estimate will not, however, affect the basis for depletion.

§ 39.23 (m)-10 *Depletion, adjustments of accounts based on bonus or advanced royalty.* (a) If a bonus in addition to royalties is received upon the grant of rights in mineral property, there shall be allowed to the payee 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 payee's basis for depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received. In the case of the payor any payment made for the acquisition of an economic interest in a mineral deposit or standing timber constitutes a capital investment in the property recoverable only through the depletion allowance.

(b) If the owner of operating rights in mineral property for a term of years is required to extract and pay for, annually a specified number of tons, or other agreed units of measurement, of such mineral, or to 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 premises, the payee shall treat an amount equal to that part of the basis for depletion allocable to the number of units so paid for in advance of extraction as 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 such payee 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 grant of mineral rights expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the grantor 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 such expiration, termination, or abandonment occurs.

(d) In lieu of the treatment provided for in paragraphs (a) and (b) of this section, the owner of an economic interest in minerals in respect of which depletion is allowed on the basis of percentage of income under § 39.23 (m)-4 or § 39.23 (m)-5 may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year or period for which such deduction is allowable under such section an amount computed on the basis of the percentages applicable as indicated in such sections; 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

(e) If a lessee or other owner of operating rights in one or more mineral properties is required to pay royalties on a specified number of units of mineral annually, whether or not extracted within the year, and may apply any amounts paid on account of units not extracted within the year against the royalty on mineral thereafter extracted, he may at his option treat the advanced royalties so paid or accrued in either one of the following manners:

(1) As deductions from gross income for the year the advanced royalties are paid or accrue; or

(2) As deductions from gross income for the year the mineral product in respect of which the advanced royalties were paid is sold.

The option contained in this paragraph shall apply only to advanced royalties paid or accrued in taxable years ending on or after December 31, 1939. Every taxpayer must make an election as to the treatment of all such advanced royalties in his return for the first taxable year ending on or after December 31, 1939, in which such amounts are paid or accrue. A taxpayer will be considered to have made an election in accordance with the manner in which such items are treated in the return. A failure to deduct any such items for the year paid or accrued will constitute an election to have all such items treated in accordance with subparagraph (2) of this paragraph. Any election made under this section is binding for all subsequent years and the taxpayer must treat all advanced royalties paid or accrued in such subsequent years in the same manner.

§ 39.23 (m)-11 *Depletion and depreciation accounts on books.* (a) 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)

(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 §§ 39.23 (m)-2, 39.23 (m)-3, 39.23 (m)-4, or 39.23 (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 §§ 39.23 (m)-3, 39.23 (m)-4, or 39.23 (m)-5.

(c) Every taxpayer to whom section 114 (b) (2) and § 39.23 (m)-3 are applicable shall keep similar accounts with respect to discovery value.

§ 39.23 (m)-12 *Statement to be attached to return when valuation, depletion, or depreciation of mineral property is claimed.* (a) Except as provided in § 39.23 (m)-13, there shall be attached to the return of every taxpayer asserting a value for any mineral property as of 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) The nature of the taxpayer's interest in the property, accompanied by a certified copy of the instrument or instruments by which it was acquired;

(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 (i) were allowed, (ii) were allowable, and (iii) 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 shall be furnished in a single statement, should be summarized, and shall be deemed to be a part of the income tax return to which it relates.

(e) Any of the information required by this section 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.

§ 39.23 (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 on the basis of percentage of income under § 39.23 (m)-4 or § 39.23 (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 § 39.23 (m)-1 (e) 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 § 39.23 (m)-1 (g), and

(3) The information required by paragraphs (a) (1), (a) (2), (a) (3), and (b) of § 39.23 (m)-12. The other information required by § 39.23 (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 in a single statement, should be summarized, and shall be deemed to be a part of the income tax return to which it relates.

§ 39.23 (m)-14 *Discovery of mines or other natural deposits (except those in respect of which percentage depletion is allowable under § 39.23 (m)-5)* (a) To entitle a taxpayer to a valuation of his property, for the purposes of depletion allowances, by reason of the discovery of a mine or minerals (other than those in respect of which percentage depletion is allowable under § 39.23 (m)-4 or § 39.23 (m)-5) 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 cost. For the purposes of this section, mines or minerals shall not be entitled to valuation upon the basis of discovery for any taxable year or period in respect to which percentage depletion is allowable under § 39.23 (m)-4 or § 39.23 (m)-5. 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 section 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 § 39.23 (m)-7, based on what is evident within 30 days after the commercially valuable character and extent of the discovered de-

posits of mineral have with reasonable certainty been established, determined, or proved.

§ 39.23 (m)–15 *Allowable capital additions in case of mines*—(a) *General rules.* (1) All expenditures in excess of net receipts from minerals sold shall be 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.

(2) 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 (i) do not increase the value of the mine, or (ii) do not decrease the cost of production of mineral units, or (iii) 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.

(b) *Special rules.* Sections 23 (cc) and 23 (ff) contain special provisions for treatment of expenditures for certain exploration and development costs (other than for acquisition or improvement of depreciable property) with respect to ores and minerals other than oil or gas. See §§ 39.23 (cc)–1 and 39.23 (ff)–1.

§ 39.23 (m)–16 *Charges to capital and to expense in 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 incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of oil and gas properties: All expenditures made by an operator 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 operator, 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. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or the gross proceeds from production, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. 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 (i) in the drilling, shooting, and cleaning of wells; (ii) in such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells; and (iii) in the construction of such derricks, tanks, pipelines, 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. Included in this option are all costs of drilling and development undertaken (directly or through a contract) by an operator of an oil and gas property whether incurred by him prior or subsequent to the formal grant or assignment to him of operating rights (a leasehold interest, or other form of operating rights, or working interest) except that in any case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the costs thereof which is attributable to such fractional interest is within this option. In the excepted cases, costs of the project undertaken, including depreciable equipment furnished, to the extent allocable to fractions of the operating rights held by others, must be capitalized as the depletable capital cost of the fractional interest thus acquired.

(2) 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 the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are returnable through depletion insofar as they are not represented by physical property. For the purposes of this section 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 the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are returnable through depreciation insofar as they are represented by physical property. 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 purpose of determining the depletion and depreciation allowances.

(4) Option with respect to cost of nonproductive wells: If the operator has elected to capitalize intangible drilling and development costs, then an additional option is accorded with respect to intangible drilling and development costs incurred in drilling a nonproductive well. Such costs incurred in drilling a nonproductive well may be deducted by the taxpaper as an ordinary loss provided a proper election is made in the return for the first taxable year beginning after December 31, 1942, in which such a nonproductive well is completed. Such election with respect to intangible drilling and development costs of nonproductive wells is a new election, and, when made, shall be binding for all subsequent years. Any taxpayer who incurs optional drilling and development costs in drilling a nonproductive well must make a clear statement of election under this option in the return for the first taxable year begining after December 31, 1942, in which such nonproductive well is completed. The absence of a clear indication in such return of an election to deduct as ordinary losses intangible drilling and development costs of nonproductive wells shall be deemed to be an election to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property.

(c) Nonoptional items distinguished:

(1) Capital items: The option with respect to intangible drilling and development costs 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 option does 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 option provided by this section, 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.

(d) This section does not grant a new option or election. Any taxpayer who made an election under paragraph (b) of § 29.23 (m)-16 of Regulations 111 (26 CFR, 1949 ed., Supps.) is, by such election, bound with respect to all optional expenditures (whether made before January 1, 1952, or after December 31, 1951) in connection with oil and gas properties. Any taxpayer who has never made expenditures for the development of oil and gas properties prior to his first taxable year beginning after December 31, 1951, must make an election with respect to intangible drilling and development costs in general in the return for the first taxable year in which the taxpayer makes such expenditures.

§ 39.23 (m)-17 *Depreciation in case of mines.* (a) The Internal Revenue Code provides that deductions for depreciation of improvements on mining property may be taken "according to the peculiar conditions in each case." 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 §§ 39.23 (l)-1 to 39.23 (l)-10, inclusive, as to deduction for depreciation and obsolescence generally. See particularly § 39.23 (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 § 39.23 (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, and 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 this section 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 §§ 39.23 (m)-1 to 39.23 (m)-19, inclusive, 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.

(h) Sections 23 (cc) and 23 (ff) provide special rules for treatment of depreciation allowances with respect to the exploration and development of a mine or other natural deposit other than oil or gas. See §§ 39.23 (cc)-1 and 39.23 (ff)-1.

§ 39.23 (m)-18 *Depreciation of improvements in case of oil and gas wells.* Taxpayers 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 § 39.23 (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 §§ 39.23 (l)-1 to 39.23 (l)-10, inclusive, as to deductions for depreciation and obsolescence generally. See particularly § 39.23 (l)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)

§ 39.23 (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.

§ 39.23 (m)-20 *Capital recoverable through depletion allowance in 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 § 39.113 (b) (1)-1. The apportionment of deductions between the several owners of economic interests in timber properties will be made as specified in § 39.23 (m)-7 (f) The cost of timber properties shall be determined in accordance with the principles indicated in § 39.23 (m)-6. For method of determining fair market value and quantity of timber, see §§ 39.23 (m)-25 to 39.23 (m)-27, inclusive. For depletion purposes the cost of the timber shall not include any part of the cost of the land.

§ 39.23 (m)-21 *Computation of allowance for depletion of timber for given year.* (a) 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 (1) 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 (2) 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 §§ 39.23 (m)-27 and 39.23 (m)-28.

(b) Where a taxpayer elects to treat the cutting of timber as a sale or exchange of such timber under the provisions of section 117 (k) (1) the allowable depletion shall be the fair market value of the timber cut during the taxable year. Such fair market value shall be the fair market value of such timber as of the first day of the taxable year in which such timber is cut.

(c) 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.

§ 39.23 (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 appproval of the Commissioner. The depletion unit should be charged when a revision of the remaining number of units of recoverable timber in the property has been made in accordance with § 39.23 (m)-26.

§ 39.23 (m)-23 *Depreciation of improvements in case of timber* (a) 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:

(1) 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

(2) 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.

(b) 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 this section 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 §§ 39.23 (l)-1 to 39.23 (l)-10, inclusive, as to deductions for depreciation and obsolescence generally. See particularly § 39.23 (l)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)

§ 39.23 (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.

§ 39.23 (m)-25 *Determination of fair market value of timber* (a) 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:

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

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

(3) 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

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

(b) 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.

(c) If, for the purpose of the equitable apportionment of depletion among the several owners of economic interests, the value of any timber property must be ascertained as of any specific date for the determination of the basis for depletion, the values of the several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the timber property in fee simple.

§ 39.23 (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.

§ 39.23 (m)-27 *Aggregating timber and land for purposes of valuation and accounting.* (a) 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.

(b) The timber accounts mentioned in paragraph (a) of this section 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 paragraph (a) of this section, 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.

(c) 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.

(d) 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.

(e) For good and substantial reasons satisfactory to the Commissoner, 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.

§ 39.23 (m)-28 *Timber depletion and depreciation accounts on books.* (a) 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 §§ 39.113 (a) (14)-1 and 39.113 (b) (1)-1 to 39.113 (b) (4)-1, inclusive.

(b) 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 § 39.23 (m)-27.) These accounts shall be credited with the amount of the depreciation and depletion deductions computed in accordance with § 39.23 (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.

§ 39.23 (n)-(o) *Statutory provisions; deductions from gross income; cross reference; charitable and other contributions.*

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

(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.

(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, or any possession of the United States, for exclusively public purposes;

(2) A corporation, trust or community chest, fund, or foundation, created or organized in the United States or in any possession thereof or under the law of the United States or of any State or Territory or of any possession of the United States, 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. For disallowance of certain charitable, etc., deductions otherwise allowable under this paragraph, see sections 3813 and 162 (g) (2);

(3) The special fund for vocational rehabilitation authorized by section 12 of the World War Veterans' Act, 1924, 43 Stat. 611 (U. S. C., Title 38, sec. 440);

(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;

(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; or

(6) The United Nations, * * * [Not applicable.]

to an amount which in all the above cases combined does not exceed 20 per centum of the taxpayer's adjusted gross income. 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 deductions if contributions and gifts exceed 90 per centum of the net income, see section 120.

[Sec. 23 (o) as amended by sec. 224 (a), Rev. Act 1939; sec. 127 (c), Rev. Act 1942; sec. 8 (b), Individual Income Tax Act 1944; sec. 1, Pub. Law 7 (80th Cong.); sec. 332 (a) Rev. Act 1950; sec. 4 (a), Pub. Law 465 (82d Cong.)]

SEC. 11. *Denial of Tax Deductions and Exemptions [Internal Security Act of 1950].* (a) Notwithstanding any other provision of law, no deduction for Federal income-tax purposes shall be allowed in the case of a contribution to or for the use of any organization if at the time of the making of such contribution (1) such organization is registered under section 7, or (2) there is in effect a final order of the Board [the Subversive Activities Control Board] requiring such organization to register under section 7. * * *

§ 39.23 (o)-1 *Contributions or gifts by individuals.* (a) 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 contribution or gift to an 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 section does not apply to contributions or gifts by estates and trusts (see section 162) For disallowance of certain charitable deductions otherwise allowable under section 23 (o) (2) see sections 3813 and 162 (g) (2) and the regulations promulgated pursuant thereto.

(b) A contribution or gift to the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, or any possession of the United States, exclusively for public purposes, is deductible.

(c) 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 20 percent of his adjusted gross income. 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) 220, and 251.

For contributions or gifts by corporations, see § 39.23 (q)-1.

(d) In the case of husband and wife making a joint return, the deduction for contributions or gifts is the aggregate of such contributions or gifts made by the spouses, and is limited to 20 percent of the aggregate adjusted gross income of the spouses.

(e) 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.

(f) 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.

(g) 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.

(h) In connecion with claims for deduction 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.

(i) For unlimited deduction if contributions or gifts and taxes in the taxable year and in each of the 10 preceding taxable years exceed 90 percent of the taxpayer's net income, see section 120.

§ 39.23 (p) *Statutory provisions; deductions from gross income; contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan.*

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

(p) *Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan.* (1) *General rule.* If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under subsection (a) but shall be deductible, if deductible under subsection (a) without regard to this subsection, under this subsection but only to the following extent:

(A) In the taxable year when paid, if the contributions are paid into a pension trust, and if such taxable year ends within or with a taxable year of the trust for which the trust is exempt under section 165 (a), in an amount determined as follows:

(i) An amount not in excess of 5 per centum of the compensation otherwise paid or accrued during the taxable year to all the employees under the trust, but such amount may be reduced for future years if found by the Commissioner upon periodical examinations at not less than five-year intervals to be more than the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan, plus

(ii) Any excess over the amount allowable under clause (i) necessary to provide with respect to all of the employees under the trust the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each such employee, as determined under regulations prescribed by the Commissioner with the approval of the Secretary, but if such remaining unfunded cost with respect to any three individuals is more than 50 per centum of such remaining unfunded cost, the amount of such unfunded cost attributable to such individuals shall be distributed over a period of at least 5 taxable years, or

(iii) In lieu of the amounts allowable under (i) and (ii) above, an amount equal to the normal cost of the plan, as determined under regulations prescribed by the Commissioner with the approval of the Secretary, plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount not in excess of 10 per centum of the cost which would be required to completely fund or purchase such pension or annuity credits as of the date when they are included in the plan, as determined under regulations prescribed by the Commissioner with the approval of the Secretary, except that in no case shall a deduction be allowed for any amount (other than the normal cost) paid in after such pension or annuity credits are completely funded or purchased.

(iv) Any amount paid in a taxable year in excess of the amount deductible in such year under the foregoing limitations shall be deductible in the succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each such succeeding year and the maximum amount deductible for such year in accordance with the foregoing limitations.

(B) In the taxable year when paid, in an amount determined in accordance with subparagraph (A) of this paragraph, if the contributions are paid toward the purchase of retirement annuities and such purchase is a part of a plan which meets the requirements of section 165 (a), (3), (4), (5), and (6), and if refunds of premiums, if any, are applied within the current taxable year or next succeeding taxable year towards the purchase of such retirement annuities.

(C) In the taxable year when paid, if the contributions are paid into a stock bonus or profit-sharing trust, and if such taxable year ends within or with a taxable year of the trust with respect to which the trust is exempt under section 165 (a), in an amount not in excess of 15 per centum of the compensation otherwise paid or accrued during the taxable year to all employees under the stock bonus or profit-sharing plan. If in any taxable year beginning after December 31, 1941, there is paid into the trust, or a similar trust then in effect, amounts less than the amounts deductible under the preceding sentence, the excess, or if no amount is paid, the amounts deductible, shall be carried forward and be deductible when paid in the succeeding taxable years in order of time, but the amount so deductible under this sentence in any such succeeding taxable year shall not exceed 15 per centum of the compensation otherwise paid or accrued during such succeeding taxable year to the beneficiaries under the plan. In addition, any amount paid into the trust in a taxable year beginning after December 31, 1941, in excess of the amount allowable with respect to such year under the preceding provisions of this subparagraph shall be deductible in the succeeding taxable years in order of time, but the amounts so deductible under this sentence in any one such succeeding taxable year together with the amount allowable under the first sentence of this subparagraph shall not exceed 15 per centum of the compensation otherwise paid or accrued during such taxable year to the beneficiaries under the plan. The term "stock bonus or profit-sharing trust" as used in this subparagraph, shall not include any trust designed to provide benefits upon retirement and covering a period of years, if under the plan the amounts to be contributed by the employer can be determined actuarially as provided in subparagraph (A). If the contributions are made to two or more stock bonus or profit-sharing trusts, such trusts shall be considered a single trust for the purposes of applying the lim ations in this subparagraph.

(D) In the taxable year when paid, if the plan is not one included in paragraphs (A), (B), or (C), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

(E) For the purposes of subparagraphs (A), (B), and (C), a taxpayer on the accrual basis shall be deemed to have made a payment on the last day of the year of accrual if the payment is on account of such taxable year and is made within sixty days after the close of the taxable year of accrual.

(F) If amounts are deductible under subparagraphs (A) and (C), or (B) and (C), or (A), (B), and (C), in connection with two or more trusts, or one or more trusts and an annuity plan, the total amount deductible in a taxable year under such trusts and plans shall not exceed 25 per centum of the compensation otherwise paid or accrued during the taxable year to the persons who are the beneficiaries of the trusts or plans. In addition, any amount paid into such trust or under such annuity plans in a taxable year beginning after December 31, 1941, in excess of the amount allowable with respect to such year under the preceding provisions of this subparagraph shall be deductible in the succeeding taxable years in order of time, but the amount so deductible under this sentence in any one such succeeding taxable year together with the amount allowable under the first sentence of this subparagraph shall not exceed 30 per centum of the compensation otherwise paid or accrued during such taxable years to the beneficiaries under the trusts or plans. This subparagraph shall not have the effect of reducing the amount otherwise deductible under subparagraphs (A), (B), and (C), if no employee is a beneficiary under more than one trust, or a trust and an annuity plan.

If there is no plan but a method of employer contributions or compensation has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, this paragraph shall apply as if there were such a plan.

(2) *Deductions under prior income tax acts.* * * * [Not applicable.]

[Sec. 23 (p) as amended by sec. 162 (b), Rev. Act 1942; sec. 202, Pub. Law 291 (79th Cong.)]

§ 39.23 (p)-1 *Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred*

payment plan; in general. (a) Section 23 (p) prescribes limitations upon deductions for amounts contributed by an employer under a pension, annuity, stock bonus, or profit-sharing plan, or under any plan of deferred compensation. It is immaterial whether the plan covers present employees only, or present and former employees, or only former employees. As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 3797 (a) (20) Section 23 (p) does not apply to a plan which does not defer the receipt of compensation. Nor does section 23 (p) apply to deductions for contributions under a plan which is primarily a dismissal wage, or unemployment benefit plan or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan, or a combination thereof. Section 23 (p) is, however, applicable to all contributions (including contributions to provide incidental benefits such as life insurance protection) under a stock bonus, pension, profit-sharing, or annuity plan, whether or not the employees' rights in such contributions are nonforfeitable, but deductions under section 23 (p) are subject to conditions and limitations under section 23 (a) as well as those particularly provided in section 23 (p)

(b) In order to be deductible under section 23 (p) contributions must be expenses which would be deductible under section 23 (a) if it were not for the provision in section 23 (p) (1) that they are deductible, if at all, only under section 23 (p) Contributions may therefore be deducted under section 23 (p) only to the extent that they are ordinary and necessary expenses during the taxable year in carrying on trade or business and are compensation for personal services actually rendered. In no case is a deduction allowable under section 23 (p) for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered. What constitutes a reasonable allowance depends upon the facts in the particular case. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year. A contribution under a plan which is primarily for the benefit of shareholders of the employer is not deductible. Such a contribution may constitute a dividend within the meaning of section 115 (a) See also §§ 39.23 (a)-6 and 39.23 (a)-8. In addition to the limitations referred to above, deductions under section 23 (p) are also subject to further conditions and limitations particularly provided therein.

(c) Section 23 (p) is not confined to formal stock bonus, pension, profit-sharing, and annuity plans, or deferred compensation plans, but it includes any method of contributions or compensation having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation. Thus, where a corporation pays pensions to such of its retired employees and in such amounts as may be determined from time to time by the board of directors or responsible officers of the company, or where a corporation is under an obligation, whether funded or unfunded, to pay a pension or other deferred compensation to an employee, there is a method having the effect of a plan deferring the receipt of compensation for which deductions are governed by section 23 (p) If an employer on the accrual basis defers paying any compensation to an employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, he shall not be allowed a deduction until the year in which the compensation is paid. This provision is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual merely because of inability to pay such compensation in the year of accrual, as, for example, where the funds of the company are not sufficient to enable payment of the compensation without jeopardizing the solvency of the company, or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year.

(d) Deductions under section 23 (p) are generally allowable only for the year for which the contribution or compensation is paid, regardless of the fact that the taxpayer may make his return on the accrual basis. Exceptions are made in the case of overpayments as provided in subparagraphs (A), (C) and (F) of section 23 (p) (1) and, as provided by section 23 (p) (1) (E) in the case of payments made by a taxpayer on the accrual basis within 60 days after the close of the taxable year of accrual. This latter provision is intended to permit a taxpayer on the accrual basis to deduct such accrued contribution or compensation, provided payment is actually made within 60 days after the close of the year of accrual.

§ 39.23 (p)-2 *Information to be furnished by employer claiming deductions.* (a) If a deduction from gross income is claimed under section 23 (p) (1) (A), (B) (C) or (F), the employer, except as otherwise provided in paragraph (b) of this section, must file the following information for each plan involved to establish that it meets the requirements of section 165 (a) or 23 (p) (1) (B), and that the deductions claimed do not exceed the amount allowable under subparagraphs (A) (B) (C) and (F) of section 23 (p) (1), as the case may be:

(1) Verified copies of all the instruments constituting or evidencing the plan, including trust indentures, group annuity contracts, specimen copy of each type of individual contract, and specimen copy of formal announcement and comprehensive detailed description to employees, with all amendments to any such instruments.

(2) A statement describing the plan which identifies it and which sets forth the name or names of the employers, the effective date of the plan and of any amendments thereto, the method of distribution or of disbursing benefits (whether by trustee, insurance company, or otherwise) the dates when the instruments or amendments were executed, the date of formal announcement and the dates when comprehensive detailed description of the plan and of each amendment thereto were made available to employees generally, the dates when the plan and when the trust or the contract evidencing the plan and of any amendments thereto were put into effect so that contributions thereunder were irrevocable and a summary of the provisions and rules relating to—

(i) Employee eligibility requirements for participation in the plan,

(ii) Employee contributions,

(iii) Employer contributions,

(iv) The basis or formula for determining the amount of each type of benefit and the requirements for obtaining such benefits and the vesting conditions,

(v) The medium of funding (e. g., self-insured, unit purchase group annuity contract, individual level annual premium retirement endowment insurance contracts, etc.) and, if not wholly insured, the medium of contributions and the kind of investments, and

(vi) The discontinuance or modification of the plan and distributions or benefit payments upon liquidation or termination.

(3) A tabulation in columnar form showing the information specified below with respect to each of the 25 highest paid employees covered by the plan in the taxable year, listed in order of their nondeferred compensation (where there are several plans of deferred compensation, the information for each of the plans may be shown on a single tabulation without repetition of the information common to the several plans)

(i) Name.

(ii) Whether an officer.

(iii) Percentage of each class of stock owned directly or indirectly by the employee or members of his family.

(iv) Whether the principal duties consist in supervising the work of other employees.

(v) Year of birth.

(vi) Length of service for employer to the close of the year.

(vii) Total nondeferred compensation paid or accrued during the taxable year with a breakdown of such compensation into the following components:

(*a*) Basic compensation and overtime pay,

(*b*) Other direct payments, such as bonuses and commissions,

(*c*) Compensation paid other than in cash, such as goods, services, insurance not directly related to the benefits or provided from funds under the plan, etc.

(viii) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto) less the employee's contributions during the year, under each other plan of deferred compensation.

(ix) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto) less the employee's contributions during the year, under the plan. If a profit-sharing or stock bonus plan, also a breakdown of such amounts into the following components:

(*a*) Amounts originally allocated in the year, and

(*b*) Amounts reallocated in the year.

(x) Amounts of employee contributions during the year under the plan.

(xi) If a pension or annuity plan,

(*a*) the retirement age and date and the form of the retirement benefit,

(*b*) the annual rate or amount of the retirement benefit, and

(*c*) the aggregate of all of the employee's contributions under the plan,

all based, in the case of an employee who is not on retirement benefit under the plan, upon the assumption of his continued employment at his current rate of compensation until his normal retirement age (or the end of the current year if later) and retirement on such date with the normal form of retirement benefit under the plan.

(4) The following totals:

(i) Total nondeferred compensation paid or accrued during the taxable year for all employees covered under the plan and also for all employees of the employer.

(ii) Total amount allocated during the year for the benefit of employees, former or retired employees, or their beneficiaries (including any insurance provided thereby or directly related thereto) less employee contributions during the year under the plan and, if a profit-sharing or stock bonus plan, also a breakdown of such total into the following components:

(*a*) Amount originally allocated in the year, and

(*b*) Amount reallocated in the year.

(5) A schedule showing the total number of employees as of the close of the year for each of the following groups, based on reasonable estimates:

(i) All employees ineligible for coverage under the plan because of requirements as to employment classification, specifying the reasons applicable to the group (as, for example, temporary, seasonal, part time, hourly pay basis, etc.)

(ii) All employees ineligible for coverage under the plan because of requirements as to length of service and not included in subdivision (i) of this subparagraph.

(iii) All employees ineligible for coverage under the plan because of requirements as to minimum age and not included in subdivision (i) or (ii) of this subparagraph.

(iv) All employees ineligible for coverage under the plan solely because of requirements as to minimum rate of compensation.

(v) All employees ineligible for coverage under the plan other than those employees included in subdivision (i) (ii) (iii) or (iv) of this subparagraph, specifying the reasons applicable to the group.

(vi) All employees ineligible for coverage under the plan for any reasons, which should be the sum of subdivisions (i) to (v) inclusive, of this subparagraph.

(vii) All employees eligible for coverage but not covered under the plan.

(viii) All employees covered under the plan.

(ix) All employees of the employer, which should be the sum of subdivisions (vi) (vii) and (viii) of this subparagraph.

If it is claimed that the requirements of section 165 (a) (3) (A) are satisfied, also the data and computations necessary to show that such requirements are satisfied.

(6) In the case of a trust, a detailed balance sheet and a detailed statement of receipts and disbursements during the year; in the case of a nontrusteed annuity plan, a detailed statement of the names of the insurers, the contributions paid by the employer and by the employees, and a statement as to the amounts and kinds of premium refunds or similar credits made available and the disposition of such credits in the year.

(7) If a pension or annuity plan, a detailed description of all the methods, factors, and assumptions used in determining costs and in adjusting the costs for actual experience under the plan (including any loadings, contingency reserves, or special factors and the basis of any insured costs or liabilities involved therein) explaining their source and application in sufficient detail to permit ready analysis and verification thereof, and, in the case of a trust, a detailed description of the basis used in valuing the investments held. Also a summary of the resulting costs or liabilities and adjustments for the year under the pension or annuity plan in sufficient detail to permit ready verification of the reasonableness thereof.

(8) A statement of the applicable limitations under section 23 (p) (1) (A) (B) (C) or (F) and an explanation of the method of determining such limitations and a summary of the data and computations necessary to determine the allowable deductions for the taxable year.

(9) A statement of the contributions paid in the taxable year, showing the date and amount of each payment. Also a summary of the deductions claimed for the taxable year for the plan with a breakdown of the deductions claimed into the following components:

(i) Under section 23 (p) (1) for contributions paid in the taxable year before giving effect to the provisions of subparagraph (F) thereof.

(ii) Under section 23 (p) (1) for contributions paid in prior taxable years beginning after December 31, 1941, in accordance with the carry-over provisions of subparagraphs (A) and (C) thereof before giving effect to the provisions of subparagraph (F) thereof.

(iii) Any reductions or increases in the deductions in accordance with the provisions of subparagraph (F) thereof.

(iv) Under section 23 (p) (2) for contributions paid to a pension trust in a taxable year beginning before January 1, 1942.

(b) If there is any change in the plan, instruments, methods, factors, or assumptions upon which the data and information specified in subparagraph (1), (2) or (7) of paragraph (a) are based, a detailed statement explaining the change and its effect must be filed with the information otherwise required for the taxable year in which the change is put into effect and, insofar as there is no such change, after the data and information specified in those subparagraphs has been filed in connection with a tax return, unless otherwise requested by the Commissioner, a statement that there is no such change may be filed in lieu of repeated filing of the information. After the information specified in subparagraph (3) of paragraph (a) has been filed for two consecutive years, unless otherwise requested by the Commissioner, so long as the plan and the method and basis of allocations are not changed, the tabulation need show such information only with respect to employees who, at any time in the taxable year, own, directly or indirectly, more than 5 percent of the voting stock, considering stock so owned by an individual's spouse or minor lineal descendant as owned by the individual for this purpose.

(c) If a deduction is claimed under section 23 (p) (1) (D) for the taxable year, the taxpayer shall furnish such information as is necessary to show that the deduction is not allowable under the other subparagraphs of section 23 (p) (1) that the amount paid is an ordinary and necessary expense, and that the employees' rights to, or derived from, such employer's contribution or such compensation were nonforfeitable at the time the contribution or compensation was paid.

(d) For the purpose of the above information, contributions paid in a taxable year should include those deemed to be so paid in accordance with the provisions of section 23 (p) (1) (E) and exclude those deemed to be paid in the prior taxable year in accordance with such provisions. As used in this section, "taxable year" refers to the taxable year of the employer and, unless otherwise requested by the Commissioner, a "year" which is not specified as a "taxable year" may be taken as the taxable year of the employer or as the plan, trust, valuation, or group contract year beginning in the taxable year of the employer provided

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the same rule is followed consistently so that there is no gap or overlap in the information furnished for each item. In any case the date or period to which each item of information furnished relates should be clearly shown. All the information required by this section should be filed with the tax return for the taxable year in which the deduction is claimed except that, unless sooner requested by the Commissioner, such information, other than that specified in subparagraphs (4) (i) and (9) of paragraph (a) may be filed within 12 months after the close of the taxable year provided there is filed with the tax return a statement that the information cannot reasonably be filed therewith, setting forth the reasons therefor.

(e) In any case all the information and data required by this section must be filed in the office of the district director of internal revenue in which the employer files his tax returns and identified for association with the appropriate returns and must be filed independently of any information and data otherwise submitted in connection with a determination of the qualification of the trust or plan under section 165 (a). The Commissioner may, in addition, require any further information that he considers necessary to determine allowable deductions under section 23 (p) or qualification under section 165 (a) and may waive the filing of such information required herein which he finds unnecessary in a particular case.

(f) Records substantiating all data and information required by this section to be filed must be kept at all times available for inspection by internal revenue officers at the main office or place of business of the employer.

§ 39.23 (p)-3 *Effect of section 162 (d) of the Revenue Act of 1942 upon deductions for contributions paid before September 1, 1942, and carried over to succeeding years.* The amount of deductions allowable under the carry-over provisions of section 23 (p) (1) (A) (iv) (see § 39.23 (p)-8) the third sentence of section 23 (p) (1) (C) (see § 39.23 (p)-10) or the second sentence of section 23 (p) (1) (F) (see § 39.23 (p)-12) for contributions paid in a taxable year beginning after December 31, 1941, depends in part upon the deductions allowable under section 23 (p) (1) (A) (B) (C) or (F) for the year in which the contributions were paid. In certain cases where the contributions were paid before September 1, 1942, deductions for the taxable year beginning in 1942 were subject to a special provision for alternative limitations in section 162 (d) (1) (C) of the Revenue Act of 1942 (see § 29.23 (p)-3 of Regulations 111 (26 CFR, 1949 ed., Supps.)).

§ 39.23 (p)-4 *Contributions of an employer to or under an employees' pension trust or annuity plan that meets the requirements of section 165 (a) application of section 23 (p) (1) (A)* (a) If contributions are paid by an employer to or under a pension trust or annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 39.23 (p)-1) the contributions are deductible under section 23 (p) (1) (A) or (B) if the further conditions provided therein are also satisfied. As used here, a "pension trust" means a trust forming part of a pension plan and an "annuity plan" means a pension plan under which retirement benefits are provided under annuity or insurance contracts without a trust. For the meaning of "pension plan" as used here, see § 39.165-1 (a) Where disability, withdrawal, insurance, or survivorship benefits incidental and directly related to the retirement benefits under a pension or annuity plan are provided for the employees or their beneficiaries by contributions under the plan, deductions on account of such incidental benefits are also covered under section 23 (p) (1) (A) or (B). See § 39.165-6 as to taxability to employees of cost of incidental insurance protection. In order to be deductible under section 23 (p) (1) (A) contributions to a pension trust must be paid in a taxable year of the employer which ends with or within a year of the trust for which it is exempt under section 165 (a). In order that contributions carried over may be deducted in a succeeding taxable year of the employer in accordance with section 23 (p) (1) (A) (iv), the succeeding year also must end with or within a taxable year of the trust for which it is exempt under section 165 (a) See § 39.23 (p)-9 as to conditions for deductions under section 23 (p) (1) (B) in the case of an annuity plan. In either case, the deductions are also subject to further limitations provided in section 23 (p) (1) (A) The limitations provided in section 23 (p) (1) (A) with an exception provided for certain years under clause (i) thereof (see § 39.23 (p)-5) are based on the actuarial costs of the plan and section 23 (p) (1) (A) requires that the costs and the limitations based on costs under that section shall be determined under regulations prescribed by the Commissioner with the approval of the Secretary (or, in certain cases under sections 23 (p) (1) (A) (i) in accordance with a finding of the Commissioner)

(b) In determining costs for the purpose of limitations under section 23 (p) (1) (A), the effects of expected mortality and interest must be discounted and the effects of expected withdrawals, changes in compensation, retirements at various ages, and other pertinent factors may be discounted or otherwise reasonably recognized. A properly weighted retirement age based on adequate analyses of representative experience may be used as an assumed retirement age. Different basic assumptions or rates may be used for different classes of risks or different groups where justified by conditions or required by contract. In no event shall costs for the purpose of section 23 (p) (1) (A) exceed costs based on assumptions and methods all of which are reasonable in view of the provisions and coverage of the plan, funding medium, reasonable expectations as to the effects of mortality and interest, reasonable and adequate regard for other factors such as withdrawal and deferred retirement, whether or not discounted, which can be expected to reduce costs materially, reasonable expenses of operation, and all other relevant conditions and circumstances. In any case, in determining the costs and limitations, an adjustment shall be made on account of any experience more favorable than that assumed in the basis of limitations for prior years, and, unless such adjustments are consistently made every year by reducing the limitations otherwise determined by any decrease in liability or cost arising from experience in the next preceding taxable year more favorable than the assumed experience on which the costs and limitations were based, the adjustment shall be made by some other method approved by the Commissioner.

(c) Any expenses incurred by the employer in connection with the plan, such as trustee's and actuary's fees, which are not provided for by contributions under it are deductible under section 23 (a) to the extent that they are ordinary and necessary.

(d) In case deductions are allowable under section 23 (p) (1) (C) as well as under section 23 (p) (1) (A) or (B) the limitations under section 23 (p) (1) (A) and (C) are determined and applied without giving effect to the provisions of section 23 (p) (1) (F) but the amounts allowable as deductions are subject to the further limitations provided in section 23 (p) (1) (F) See § 39.23 (p)-12.

§ 39.23 (p)-5 *Pension and annuity plans; limitations under section 23 (p) (1) (A) (i)* (a) Subject to the applicable general conditions and limitations (see § 39.23 (p)-4) the initial limitation under section 23 (p) (1) (A) (i) is 5 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the pension or annuity plan. This initial 5-percent limitation applies to the first taxable year for which a deduction is allowed for contributions to or under such a plan and also applies to any subsequent year for which the 5-percent figure is not reduced by the Commissioner as provided below. For years to which the initial 5-percent limitation applies, no adjustment on account of prior experience is required. If the contributions do not exceed the initial 5-percent limitation in the first taxable year to which this limitation applies, the taxpayer need not submit actuarial data for such year.

(b) For the first taxable year following the first year to which the initial 5-percent limitation applies, and for every fifth year thereafter, or more frequently where preferable to the taxpayer, the taxpayer shall submit with his return a certification by a qualified actuary, or by the company underwriting a nontrusteed annuity plan, of the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan with a statement explaining all the methods, factors, and assumptions used in determining such amount. This amount may be determined as the sum of (1) the unfunded past service cost as of the beginning of the year, and (2) the normal cost for the year, all determined

by methods, factors, and assumptions appropriate as a basis of limitations under section 23 (p) (1) (A) (iii) Whenever requested by the Commissioner, a similar certification and statement shall be submitted for the year or years specified in such request. The Commissioner will make periodical examinations of such data at not less than 5-year intervals and will reduce the limitation under section 23 (p) (1) (A) (i) below the 5-percent limitation for the years with respect to which he finds that the 5-percent limitation exceeds the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan. Where the limitation is so reduced, the reduced limitation shall apply until the Commissioner finds that a subsequent actuarial valuation shows a change to be necessary. Such subsequent valuation may be made by the taxpayer at any time and submitted to the Commissioner with a request for a change in the limitation.

(c) For the purpose of limitations under section 23 (p) (1) (A) (i) "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 165 (a) including a plan that qualifies under section 23 (p) (1) (B) Where two or more pension or annuity plans cover the same employee, under section 23 (p) (1) (A) (i) the deductions with respect to each such plan are subject to the limitations applicable to the particular plan and the total deductions for all such plans are also subject to the limitations which would be applicable thereto if they constituted a single plan. Where, because of the particular provisions applicable to a large class of employees under a plan, the costs with respect to such employees are nominal in comparison with their compensation, after the first year to which the initial 5-percent limitation applies, deductions under section 23 (p) (1) (A) (i) are subject to limitations determined by considering the plan applicable to such class as if it were a separate plan. Deductions are allowable to the extent of the applicable limitations under section 23 (p) (1) (A) (i) even where these are greater than the applicable limitations under section 23 (p) (1) (A) (ii) or section 23 (p) (1) (A) (iii)

§ 39.23 (p)-6 *Pension and annuity plans; limitations under section 23 (p) (1) (A) (ii)* (a) Subject to the applicable general conditions and limitations (see § 39.23 (p)-4) under section 23 (p) (1) (A) (ii) deductions may be allowed to the extent of limitations based on costs determined by distributing the remaining unfunded cost of the past and current service credits with respect to all employees covered under the trust or plan as a level amount or level percentage of compensation over the remaining service of each such employee except that, as to any three individuals with respect to whom more than 50 percent of such remaining unfunded cost is attributable, the remaining unfunded cost attributable to such individuals shall be distributed over a period of at least five taxable years.

(b) The determination of costs as a basis of deductions under section 23 (p) (1) (A) (ii) may be illustrated by a case where it is estimated actuarially as of the beginning of the plan on the basis of appropriate assumptions and factors that employer contributions of 4 percent of compensation of each covered employee during his remaining service will be sufficient to provide the current service credits of all employees under the plan and employer contributions of 3 percent of compensation of each covered employee during his remaining service will be sufficient to provide the past service credits of all employees under the plan, so that the estimated cost for the first year is 7 percent of compensation of covered employees.

(c) The statutory limitation for any taxable year under section 23 (p) (1) (A) (ii) is any excess of the amount necessary for the year on the basis of the costs over the amount allowable as a deduction under section 23 (p) (1) (A) (i) all determined under regulations prescribed by the Commissioner with the approval of the Secretary.

(d) For this purpose, such excess, adjusted for prior experience, may be computed for each year as follows; all determinations being made as of the beginning of the year:

(1) Determine the value of all benefits expected to be paid after the beginning of the year for all employees, any former employees, and any other beneficiaries, then covered under the plan.

(2) If employees contribute under the plan, determine the value of all contributions expected to be made after the beginning of the year by employees then covered under the plan.

(3) Determine the value of all funds of the plan as of the beginning of the year.

(4) Determine the amount remaining to be distributed as a level amount or as a level percentage of compensation over the remaining future service of each employee by subtracting from subparagraph (1) of this paragraph the sum of subparagraphs (2) and (3) of this paragraph.

(5) Determine the value of all compensation expected to be paid after the beginning of the year to all employees then covered under the plan.

(6) Determine an accrual rate for each employee by dividing subparagraph (5) of this paragraph into subparagraph (4) of this paragraph.

(7) Compute the excess under section 23 (p) (1) (A) (ii) for the year by multiplying the compensation paid to all employees covered under the plan during the year by any excess of subparagraph (6) of this paragraph over 5 percent. In general, where this method is used, the limitation under section 23 (p) (1) (A) (ii) will be equal to the excess so computed without further adjustment on account of prior favorable experience, provided all the factors and assumptions used are reasonable in view of all applicable considerations (see § 39.23 (p)-4) and provided subparagraph (5) of this paragraph is not less than five times the annual rate of compensation in effect at the beginning of the year.

(e) Instead of determining the excess deductible under section 23 (p) (1) (A) (ii) by the above method, such excess may be based upon costs determined by some other method which is reasonable and appropriate under the circumstances. Thus, such excess may be based on the amounts necessary with respect to each individual covered employee to provide the remaining unfunded cost of all his benefits under the plan distributed as a level amount over the period remaining until the normal commencement of his retirement benefits, in accordance with other generally accepted actuarial methods which are reasonable and appropriate in view of the provisions of the plan and the funding medium. In view of the relationship of section 23 (p) (1) (A) (ii) to sections 23 (p) (1) (A) (i) and 23 (p) (1) (A) (iii) however, if the excess is determined by a method other than that set forth in the preceding paragraph, the total limitations under sections 23 (p) (1) (A) (i) and section 23 (p) (1) (A) (ii) combined must be determined by a method approved by the Commissioner, except where they do not exceed the limitations under section 23 (p) (1) (A) (iii) adjusted for prior favorable experience.

§ 39.23 (p)-7 *Pension and annuity plans; limitations under section 23 (p) (1) (A) (iii)* (a) Subject to the applicable general conditions and limitations (see § 39.23 (p)-4) under section 23 (p) (1) (A) (iii) in lieu of amounts deductible under the limitations of section 23 (p) (1) (A) (i) and section 23 (p) (1) (A) (ii) deductions may be allowed to the extent of limitations based on normal and past service or supplementary costs of providing benefits under the plan. "Normal cost" for any year is the amount actuarially determined which would be required as a contribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. Past service or supplementary cost at any time is the amount actuarially determined which would be required at such time to meet all the future benefits provided under the plan which would not be met by future normal costs and employee contributions with respect to the employees covered under the plan at such time.

(b) The limitations under section 23 (p) (1) (A) (iii) for any taxable year is the sum of normal cost for the year plus an amount not in excess of one-tenth of the past service or supplementary cost as of the date the past service or supplementary credits are provided under the plan, all determined under regulations prescribed by the Commissioner with the approval of the Secretary. For this purpose the normal costs may be determined by any generally accepted actuarial method and may be expressed

either as (1) the aggregate of level amounts with respect to each employee covered under the plan, (2) a level percentage of payroll with respect to each employee covered under the plan, or (3) the aggregate of the single premium or unit costs for the unit credits accruing during the year with respect to each employee covered under the plan, provided, in any case, that the method is reasonable in view of the provisions and coverage of the plan, funding medium, and other applicable considerations. The limitation may include one-tenth of the past service or supplementary cost as of the date the provisions resulting in such cost were put into effect, but is subject to adjustments for prior favorable experience. See § 39.23 (p)-4. In any case past service or supplementary costs shall not be included in the limitation for any year when the amount required to fully fund or purchase such past service or supplementary credits has been deducted and no deduction is allowable for any amount (other than the normal cost) which is paid in after such credits are fully funded or purchased.

§ 39.23 (p)-8 *Pension and annuity plans; contributions in excess of limitations under section 23 (p) (1) (A) application of section 23 (p) (1) (A) (iv)* Where contributions paid by an employer in a taxable year beginning after December 31, 1941, to or under a pension or annuity plan exceed the limitations applicable under section 23 (p) (1) (A) but otherwise satisfy the conditions for deduction under section 23 (p) (1) (A) or (B) then in accordance with section 23 (p) (1) (A) (iv) the excess contributions are carried over and are deductible in succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each such succeeding year and the limitation applicable to such year under sections 23 (p) (1) (A) (i) 23 (p) (1) (A) (ii) or 23 (p) (1) (A) (iii) The provisions of section 23 (p) (1) (A) (iv) are to be applied before giving effect to the provisions of section 23 (p) (1) (F) for any year. The carry-over provisions of section 23 (p) (1) (A) (iv) before effect has been given to section 23 (p) (1) (F), may be illustrated by the following example for a plan put into effect in a taxable year ending December 31, 1952:

Taxable year ending Dec. 31, 1952:	
Amount of contributions paid in year	$100,000
Limitation applicable to year	60,000
Amount deductible for year	60,000
Excess carried over to succeeding years	40,000
Taxable year ending Dec. 31, 1953:	
Amount of contributions paid in year	25,000
Carried over from previous years	40,000
Total deductible subject to limitation	65,000
Limitation applicable to year	50,000
Amount deductible for year	50,000
Excess carried over to succeeding years	15,000
Taxable year ending Dec. 31, 1954:	
Amount of contributions paid in year	$10,000
Carried over from previous years	15,000
Total deductible subject to limitation	25,000
Limitation applicable to year	45,000
Amount deductible for year	25,000
Excess carried over to succeeding years	None

In the case of contributions paid before September 1, 1942, which are carried over to taxable years beginning after December 31, 1951, the provisions of section 23 (p) (1) (A) (iv) are applied after giving effect to the special provision for alternative limitations in section 162 (d) (1) (C) of the Revenue Act of 1942 for the taxable year beginning in 1942 (see § 29.23 (p)-3 of Regulations 111 (26 CFR, 1949 ed., Supps.))

§ 39.23 (p)-9 *Contributions of an employer under an employees' annuity plan which meets the requirements of section 165 (a) application of section 23 (p) (1) (B)* (a) If contributions are paid by an employer under an annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 39.23 (p)-1), the contributions are deductible under section 23 (p) (1) (B) if the further conditions provided therein are satisfied. For the meaning of "annuity plan" as used here, see § 39.23 (p)-4. In order that contributions by the employer may be deducted under section 23 (p) (1) (B) all of the following conditions must be satisfied:

(1) The contributions must be paid toward the purchase of retirement annuities (or for disability, severance, insurance, or survivorship benefits incidental and directly related to such annuities) under an annuity plan for the exclusive benefit of the employer's employees or their beneficiaries. See § 39.165-1 (a)

(2) The contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it meets the applicable requirements with respect to discrimination set out in section 165 (a) (3) (4), (5) and (6) In order that contributions carried over may be deducted in a succeeding taxable year of the employer in accordance with section 23 (p) (1) (A) (iv), the succeeding year also must end with or within a taxable year of the plan for which it meets such requirements. See §§ 39.165-3 and 39.165-4. These requirements are considered to be satisfied for the period beginning with the date on which an annuity plan was put into effect and ending with the fifteenth day of the third month following the close of the taxable year of the employer in which the plan was put into effect, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. See section 162 (d) (2) (B) of the Revenue Act of 1942, as amended by Public Law 511 (78th Cong.), approved December 20, 1944, as set forth preceding § 39.165-1, and § 39.165-5.

(3) There must be a definite written arrangement between the employer and the insurer that refunds of premiums, if any, shall be applied within the taxable year of the employer in which received or within the next succeeding taxable year toward the purchase of retirement annuities (or for disability, severance, insurance, or survivorship benefits incidental and directly related to such annuities) under the plan. For the purpose of this condition, "refunds of premiums" means payments by the insurer on account of credits such as dividends, experience rating credits, or surrender or cancellation credits. The arrangement may be in the form of contract provisions or written directions of the employer or partly in one form and partly in another. This condition will be considered satisfied where

(i) All credits are applied regularly, as they are determined, toward the premiums next due under the contracts before any further employer contributions are so applied and

(ii) Under the arrangement,

(*a*) No refund of premiums may be made during continuance of the plan unless applied as aforesaid and

(*b*) If refunds of premiums may be made after discontinuance of the plan on account of surrenders or cancellations before all retirement annuities provided under the plan with respect to service before its discontinuance have been purchased, such refunds will be applied in the taxable year of the employer in which received, or in the next succeeding taxable year, to purchase retirement annuities for employees by a procedure which does not contravene the conditions of section 165 (a) (4).

(b) Where the above conditions are satisfied, the amounts of deductions under section 23 (p) (1) (B) are governed by the limitations provided in section 23 (p) (1) (A). See §§ 39.23 (p)-4 to 39.23 (p)-8, inclusive.

§ 39.23 (p)-10 *Contributions of an employer to an employees' profit-sharing or stock bonus trust that meets the requirements of section 165 (a), application of section 23 (p) (1) (C)* (a) If contributions are paid by an employer to a profit-sharing or stock bonus trust for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 39.23 (p)-1) the contributions are deductible under section 23 (p) (1) (C) if the further conditions provided therein are also satisfied. In order to be deductible under section 23 (p) (1) (C) the contributions must be paid in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 165 (a) and the trust must not be designed to provide retirement benefits for which the contributions can be determined actuarially. In order that contributions carried over may be deducted in a succeeding taxable year of the employer in accordance with the third sentence of section 23 (p) (1) (C) the succeeding year also must end with or within a taxable

year of the trust for which it is exempt under section 165 (a)

(b) The amount of deductions under section 23 (p) (1) (C) for any taxable year is subject to limitations based on the compensation otherwise paid or accrued during such taxable year to the employees who, in such year, are beneficiaries of the trust funds accumulated under the plan. For this purpose "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 165 (a) including a plan that qualifies under section 23 (p) (1) (B) The limitations under section 23 (p) (1) (C) apply to the total amount deductible for contributions to the trust regardless of the manner in which the funds of the trust are invested, applied, or distributed, and no other deduction is allowable on account of any benefits provided by contributions to the trust or by the funds thereof. Where contributions are paid to two or more profit-sharing or stock bonus trusts satisfying the conditions for deduction under section 23 (p) (1) (C) such trusts are considered as a single trust in applying these limitations.

(c) The primary limitation on deductions for a taxable year is 15 percent of the compensation otherwise paid or accrued during such taxable year to the employees who, in such year, are beneficiaries of the trust funds accumulated under the plan. So long as the contributions do not in any year exceed the primary limitation, this is the only limitation under section 23 (p) (1) (C) which has any effect.

(d) In order that the deductions may average 15 percent of compensation otherwise paid or accrued over a period of years where contributions in some taxable year beginning after December 31, 1941, are less than the primary limitation but contributions in some succeeding taxable year exceed the primary limitation, deductions in each succeeding year are subject to a secondary limitation instead of to the primary limitation. The secondary limitation for any year is equal to the lesser of (1) twice the primary limitation for the year, or (2) any excess of (i) the aggregate of the primary limitations for the year and for all prior years beginning after December 31, 1941, over (ii) the aggregate of the deductions allowed or allowable under the limitations provided in section 23 (p) (1) (C) for all prior years beginning after December 31, 1941.

(e) In any case where the contributions in a taxable year beginning after December 31, 1941, exceed the amount allowable as a deduction for the year under section 23 (p) (1) (C) the excess is deductible in succeeding taxable years, in order of time, in which the contributions are less than the primary limitations, so that the total deduction for any such succeeding year is equal to the primary limitation for such year but not more than the sum of the contributions in such year and the excess contributions not deducted under the limitations of section 23 (p) (1) (C) for prior years beginning after December 31, 1941.

(f) In applying the provisions of paragraphs (d) and (e) of this section in the case of deductions for contributions paid before September 1, 1942, the deductions allowed or allowable under the limitations of section 23 (p) (1) (C) for the taxable year beginning in 1942 and the excess contributions for the taxable year beginning in 1942 are computed after giving effect to the provisions of section 162 (d) (1) (C) of the Revenue Act of 1942. See § 29.23 (p)-3 of Regulations 111 (26 CFR, 1949 ed., Supps.)

(g) In case deductions are allowable under section 23 (p) (1) (A) or (B), as well as under section 23 (p) (1) (C), the limitations under section 23 (p) (1) (A) and (C) are determined and applied without giving effect to the provisions of section 23 (p) (1) (F), but the amounts allowable as deductions are subject to the further limitations provided in sections 23 (p) (1) (F) See § 39.23 (p)-12.

(h) The provisions of section 23 (p) (1) (C), before giving effect to section 23 (p) (1) (F), may be illustrated as follows:

Illustration of provisions of section 23 (p) (1) (C) for a plan put into effect in the taxable (calendar) year 1952, before giving effect to section 23 (p) (1) (F) (all figures represent thousands of dollars)

	Taxable (calendar) years						
	1952	1953	1954	1955	1956	1957	1958
1. Amount of contributions:							
(i) In taxable year	65	10	15	100	70	40	30
(ii) Carried over from prior taxable years	0	8	0	0	4	5	3
2. Primary limitation applicable to year:							
15 percent of covered compensation in year [1]	57	54	51	48	45	42	30
3. Secondary limitation applicable to year:							
(i) Twice primary limitation	------	------	------	96	90	84	------
(ii) (a) Aggregate primary limitations (see item 2)	------	------	------	210	255	297	------
(b) Aggregate prior deductions (see item 4 (iii))	------	------	------	90	180	255	------
(c) Excess of (a) over (b)	------	------	------	120	69	42	------
(iii) Lesser of (i) or (ii)	------	------	------	96	69	42	------
4. Amount deductible for year on account of:							
(i) Contributions in year	57	10	15	96	69	40	30
(ii) Contributions carried over	0	8	0	0	0	2	3
(iii) Total	57	18	15	96	69	42	33
5. Excess contributions carried over to succeeding years	8	0	0	4	5	3	0

[1] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries of trust funds accumulated under the plan in the year.

§ 39.23 (p)-11 *Contributions of an employer under a plan that does not meet the requirements of section 165 (a) application of section 23 (p) (1) (D)* Section 23 (p) (1) (D) covers all cases for which deductions are allowable under section 23 (p) (1) but not allowable under subparagraphs (A) (B) (C) or (F) of such section. No deduction is allowable under section 23 (p) (1) (D) for any contribution paid or accrued by an employer under a stock bonus, pension, profit-sharing, or annuity plan, or for any compensation paid or accrued on account of any employee under a plan deferring the receipt of such compensation, except for the year when paid, and then only to the extent allowable under section 23 (p) (1) See § 39.23 (p)-1. If payments are made under such a plan and the amounts are not deductible under the other subparagraphs of section 23 (p) (1), they are deductible under subparagraph (D) to the extent that the rights of individual employees to, or derived from, such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid. As to what constitutes nonforfeitable rights of an employee, see § 39.165-7. If an amount is accrued but not paid during the taxable year, no deduction is allowable for such amount for such year. If an amount is paid during the taxable year but the rights of the employee therein are forfeitable at the time the amount is paid, no deduction is allowable for such amount for any taxable year.

§ 39.23 (p)-12 *Contributions of an employer where deductions are allowable under section 23 (p) (1) (A) or (B) and also under section 23 (p) (1) (C), application of section 23 (p) (1) (F)* (a) Where deductions are allowable under section 23 (p) (1) (A) or (B) on account of contributions under a pension or annuity plan and deductions are also allowable under section 23 (p) (1) (C) for the same taxable year, on account of contributions to a profit-sharing or stock bonus trust, the total deductions under these sections are subject to the provisions of section 23 (p) (1) (F) unless no employee who is a beneficiary under the trusts or plans for which deductions are allowable under section 23 (p) (1) (A) or (B) is also a beneficiary under the trusts for which deductions are allowable under section 23 (p) (1) (C) The provisions of section 23 (p) (1) (F) apply only to deductions for overlapping trusts or plans, i. e., for all trusts or plans for which deductions are allowable under section 23 (p) (1) (A) (B) or (C) except (1) any trust or plan for which deductions are allowable under section 23 (p) (1) (A) or (B) and which does not cover any employee who is also covered under a trust for which deductions are allowable under section 23 (p) (1) (C) and (2) any trust for which deductions are allowable under section 23 (p) (1) (C) and which does not cover any employee who is also covered under a trust or plan for which deductions are allowable under section 23 (p) (1) (A) or (B) The limitations under section

23 (p) (1) (F) for any taxable year are based on the compensation otherwise paid or accrued during the year to all the employees who are beneficiaries under the overlapping trusts or plans in the year. For this purpose "compensation, otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualified under section 165 (a) including a plan that qualifies under section 23 (p) (1) (B) The employees who are beneficiaries under overlapping trusts or plans in a year include all the employees who, in the year, are beneficiaries of the funds accumulated under one or more of the overlapping trusts or plans.

(b) Under section 23 (p) (1) (F) any excess of the total amount otherwise deductible for the taxable year under section 23 (p) (1) (A) (B) or (C) for overlapping trusts or plans over 25 percent of the compensation otherwise paid or accrued during the year to all the employees who are beneficiaries under such trusts or plans is not deductible for such year but is deductible for succeeding taxable years, in order of time, so that the total deduction for such trusts or plans for a succeeding taxable year is equal to the lesser of

(1) 30 percent of the compensation otherwise paid or accrued during the taxable year to all the employees who are beneficiaries under such trusts or plans in the year, or

(2) The sum of (i) the smaller of (*a*) 25 percent of the compensation otherwise paid or accrued during the taxable year to all the employees who are beneficiaries under such trusts or plans in the year, or (*b*) the total of the amounts otherwise deductible under section 23 (p) (1) (A) (B) or (C) for the year for such trusts or plans and (ii) any carry-over to the year from prior years under section 23 (p) (1) (F) i. e., any excess otherwise deductible under section 23 (p) (1) (A), (B), or (C) for a prior taxable year beginning after December 31, 1941, but not deducted for a prior taxable year because of the limitations under section 23 (p) (1) (F)

(c) The limitations under section 23 (p) (1) (F) are determined and applied after all the limitations, deductions otherwise allowable, and carry-overs under section 23 (p) (1) (A) (B) and (C) have been determined and applied, and, in particular, after effect has been given to the carry-over provision in section 23 (p) (1) (A) (iv) and in the second and third sentences of section 23 (p) (1) (C) Where the limitations under section 23 (p) (1) (F) reduce the total amount deductible, the excess deductible in succeeding years is treated as a carry-over which is distinct from, and additional to, any excess contributions carried over and deductible in succeeding years under the provisions in section 23 (p) (1) (A) (iv) or in the third sentence of section 23 (p) (1) (C) The application of the provisions of section 23 (p) (1) (F) and the treatment of carry-overs for a case where the taxable years are calendar years and the overlapping trusts or plans consist of a pension trust and a profit-sharing trust put into effect in 1952 and covering the same employees may be illustrated as follows:

Illustration of application of provisions of section 23 (p) (1) (F) and of treatment of carry-overs for overlapping pension and profit-sharing trusts put into effect in 1952 and covering the same employees (all figures represent thousands of dollars)

	Taxable (calendar) years			
	1952	1953	1954	1955
BEFORE GIVING EFFECT TO SECTION 23 (p) (1) (F)				
Pension trust contributions and limitations, deductions, and carry-overs under section 23 (p) (1) (A):				
1. Contributions paid in year	215	85	140	60
2. Contributions carried over from prior years	0	5	0	20
3. Total deductible for year subject to limitation	215	90	140	80
4. Limitation applicable to year	210	175	120	85
5. Amount deductible for year	210	90	120	80
6. Contributions carried over to succeeding years	5	0	20	0
Profit-sharing trust contributions and limitations, deductions, and carry-overs under section 23 (p) (1) (C):				
7. Contributions paid in year	200	125	105	65
8. Contributions carried over from prior years	0	35	10	0
9. Total deductible for year subject to limitation	200	160	115	65
10. Limitation applicable to year	165	150	135	[1] 110
11. Amount deductible for year	165	150	115	65
12. Contributions carried over to succeeding years	35	10	0	0
APPLICATION OF SECTION 23 (p) (1) (F)				
Totals for pension and profit-sharing trust:				
13. Amount deductible for year under section 23 (p) (1) (F):				
(1) 30 percent of compensation covered in year [2]	(3)	300	270	180
(2) (i) (*a*) 25 percent of compensation covered in year [2]	275	250	225	150
(*b*) Total amount otherwise deductible for year: item 5 plus item 11	375	240	235	145
(*c*) Smaller of (*a*) or (*b*)	275	240	225	145
(ii) Carry-over from prior years under section 23 (p) (1) (F)	0	100	40	10
(iii) Sum of (i) (*c*) and (ii)	275	340	265	155
(3) Amount deductible: Lesser of (1) or (2) (iii)	275	300	265	155
14. Carry-over to succeeding years under section 23 (p) (1) (F): item 13 (2) (ii) plus item 13 (2) (i) (*b*) minus item 13 (3)	100	40	10	0

[1] Includes carry-over of 20 from 1954.
[2] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries under the trusts in the year.
[3] 30 percent limitation not applicable to first year of plan.

(d) In applying the provisions of section 23 (p) (1) (F) in the case of deductions for contributions paid prior to September 1, 1942, the amounts otherwise deductible under section 23 (p) (1) (A) (B) or (C) for the taxable year beginning in 1942 and any carry-over from that year under section 23 (p) (1) (F) are computed after giving effect to the provisions of section 162 (d) (1) (C) of the Revenue Act of 1942. See § 29.23 (p)-12 of Regulations 111 (26 CFR, 1949 ed., Supps.)

§ 39.23 (q) *Statutory provisions; deductions from gross income; charitable and other contributions by corporations.*

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:

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

(2) A corporation, trust, or community chest, fund, or foundation, created or organized in the United States or in any possession thereof or under the law of the United states, or of any State or Territory, or of the District of Columbia, or of any possession of the United States, organized and operated exclusively for religious, charitable, scientific, veteran rehabilitation service, literary, or educational purposes or for the prevention of cruelty to children (but in the case of contributions or gifts to a trust, chest, fund, or foundation, payment of which is made within a taxable year beginning after December 31, 1948, only if such contributions or gifts are to be used within the United States or any of its possessions 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. For disallowance of certain charitable, etc., deductions otherwise allowable under this paragraph, see sections 3813 and 162 (g) (2); or

(3) Posts or organizations of war veterans, or auxiliary units of, or trusts or foundations for, any such posts or organizations, if such posts, organizations, units, trusts, or foundations are organized in the United States or any of its possessions, and if no part of their net earnings inure to the benefit of any private shareholder or individual; or

(4) the United Nations, but only if such contributions or gifts (A) are to be used exclusively for the acquisition of a site in the city of New York for its headquarters, and (B) are made after December 1, 1946, and before December 2, 1947;

to an amount which does not exceed 5 per centum of the taxpayer's net income as computed without the benefits 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.

In the case of a corporation reporting its net income on the accrual basis, at the election of the taxpayer any contribution or gift payment of which is made after the close of the taxable year and on or before the 15th day of the third month following the close of such year shall, for the purposes of this subsection, be considered as paid during such taxable year if, during such year, the board of directors authorized such contribution or gift. Such election shall be made only at the time of the filing of the return for the taxable year, and shall be signified in such manner as the Commissioner, with the approval of the Secretary, shall by regulations prescribe.

[Sec. 23 (q) as amended by sec. 224 (b), Rev. Act 1939; sec. 125, Rev. Act 1942; sec. 114, Rev. Act. 1943; sec. 2, Pub. Law 7 (80th Cong.); sec. 16, Pub. Law 384 (80th Cong.); sec. 3 (a), Pub. Law 378 (81st Cong.); sec. 332 (b), Rev. Act 1950]

SEC. 11. *Denial of tax deductions and exemptions* [Internal Security Act of 1950]. (a) Notwithstanding any other provision of law, no deduction for Federal income-tax purposes shall be allowed in the case of a contribution to or for the use of any organization if at the time of the making of such contribution (1) such organization is registered under section 7, or (2) there is in effect a final order of the Board [the Subversive Activities Control Board] requiring such organization to register under section 7. * * *

§ 39.23 (q)-1 *Contributions or gifts by corporations.* (a) A corporation may, subject to the limitations provided by section 23 (q) deduct from its gross income contributions or gifts to organizations described in section 23 (q) Except as otherwise provided in paragraph (c) of this section, such deduction shall, to the extent provided by section 23 (q) be allowed 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 § 39.23 (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. For disallowance of certain charitable, etc., deductions otherwise allowable under section 23 (q) (2) see sections 3813 and 162 (g) (2) and the regulations promulgated pursuant thereto.

(b) The provisions of § 39.23 (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)

(c) A corporation reporting its net income on the accrual basis may elect to have considered as paid during the taxable year any contribution or gift to organizations described in section 23 (q), with the exceptions hereinbefore described, payment of which contribution or gift is made after the close of the taxable year and on or before the fifteenth day of the third month following the close of such year if, during such year, the board of directors authorized such contribution or gift. Such election shall be made only at the time of the filing of the return for the taxable year and shall be signified by reporting such contribution or gift on the return. There shall be attached to such return a written declaration that the resolution authorizing the contribution or gift was adopted by the board of directors during the taxable year, and such declaration shall be verified by a statement signed by the president or other principal officer of the corporation that it is made under the penalties of perjury. With respect to contributions or gifts authorized on or after January 1, 1953, there shall be attached to the return, in addition to the written declaration referred to in the preceding sentence, a copy of the resolution of the board of directors authorizing such contribution or gift.

§ 39.23 (r) *Statutory provisions; deductions from gross income; dividends paid by banking corporations.*

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

(r) *Dividends paid by banking corporations.* (1) In the case of mutual savings banks, cooperative banks, and domestic building and loan associations, amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

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

[Sec. 23 (r) as amended by sec. 813 (f), Rev. Act. 1951]

§ 39.23 (r)-1 *Dividends paid by mutual savings banks, building and loan associations, and cooperative banks*—(a) *In general.* (1) A mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit may deduct from gross income amounts which during the taxable year are paid to or credited to the accounts of depositors or holders of accounts, as dividends on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

(2) The deduction provided in section 23 (r) (1) is applicable to the taxable year in which amounts credited as dividends become withdrawable by the depositor or holder of account subject only to customary notice of intention to withdraw. Thus, amounts credited as dividends as of the last day of the taxable year which are not withdrawable by depositors or holders of accounts until the business day next succeeding are deductible under this section in the year subsequent to the taxable year in which they were credited. A deduction under this section will not be denied by reason of the fact that amounts credited as dividends, otherwise deductible under this section, are subject to the terms of a pledge agreement between the institution and the depositor or holder of account. In the case of a building and loan association having nonwithdrawable capital stock represented by shares, no deduction is allowable under this section for amounts paid or credited as dividends on such shares.

(b) *Serial associations, bonus plans, etc.* In the case of a building and loan association which operates in whole or in part as a serial association, which maintains a bonus plan, or which issues shares subject to fines, penalties, forfeitures, or other withdrawal fees, there is deductible under section 23 (r) (1) the total amount credited as dividends upon such shares, credited to a bonus account for such shares, or allocated to a series of shares for the taxable year, notwithstanding that as a customary condition of withdrawal:

(1) Amounts invested in, and earnings credited to, series shares must be withdrawn in multiples of even shares, or

(2) Such association has the right, pursuant to by-law, contract, or otherwise, to retain or recover a portion of the total amount invested in, or credited as earnings upon, such shares, such bonus account or series of shares, as a fine, penalty, forfeiture or other withdrawal fee.

In any taxable year in which the right referred to in subparagraph (2) of this paragraph is exercised, there is includible in the gross income of such association for such taxable year, amounts retained or recovered by the association pursuant to the exercises of such right.

§ 39.23 (r)-2 *Dividends paid by certain banking corporations other than mutual savings banks, building and loan associations, and cooperative banks.* For deduction of dividends paid by certain banking corporations other than mutual savings banks, building and loan associations, and cooperative banks, see section 121.

§ 39.23 (s)-(u) *Statutory provisions; deductions from gross income; cross references; alimony, etc., payments.*

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

(s) *Net operating loss deductions.* For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

[Sec. 23 (s) as added by sec. 211 (a), Rev. Act 1939]

(t) *Amortization deduction.* The deduction for amortization provided in section 124 and section 124A.

[Sec. 23 (t) as added by sec. 301, Second Rev. Act 1940; amended by sec. 216 (b), Rev. Act 1950]

(u) *Alimony, etc., payments.* In the case of a husband described in section 22 (k), amounts includible under section 22 (k) in

the gross income of his wife, payment of which is made within the husband's taxable year. If the amount of any such payment is, under section 22 (k) or section 171, stated to be not includible in such husband's gross income, no deduction shall be allowed with respect to such payment under this subsection.

[Sec. 23 (u) as added by sec. 120 (b), Rev. Act 1942]

§ 39.23 (u)-1 *Periodic alimony payments.* (a) A deduction is allowable under section 23 (u) with respect to periodic payments in the nature of, or in lieu of, alimony or an allowance for support actually paid by the taxpayer during his taxable year and required to be included in the income of the payee wife or former wife, as the case may be, under section 22 (k) As to the amounts required to be included in the income of the wife or former wife, as the case may be, see § 39.22 (k)-1. For definition of husband and wife in such cases, see section 3797 (a) (17)

(b) The deduction under section 23 (u) is allowed only to the obligor spouse. It is not allowed to an estate, trust, corporation, or any other person who may pay the alimony obligation of such obligor spouse. The obligor spouse, however, is not allowed a deduction for any periodic payment includible under section 22 (k) in the income of the wife or former wife, as the case may be, which payment is attributable to property transferred in discharge of his obligation and which, under section 22 (k) or section 171, is stated not to be includible in his gross income.

(c) The following examples illustrate cases in which a deduction is or is not allowed under section 23 (u)

Example (1). Pursuant to the terms of a decree of divorce, H, in 1952, transfers securities valued at $100,000 in trust for the benefit of W, which fully discharges all his obligations to W. The periodic payments made by the trust to W are required to be included in W's income under section 22 (k). Such payments are stated in section 22 (k) not to be includible in H's income and, therefore, under section 23 (u) are not deductible from his income.

Example (2). A decree of divorce obtained by W from H incorporated a previous agreement of H to establish a trust, the trustees of which were instructed to pay W $5,000 a year for her life. The court retained jurisdiction to order H to provide further payments if necessary for the support of W. In 1952 the trustees paid to W $4,000 from the income of the trust and $1,000 from the corpus of the trust. Under the provisions of sections 22 (k) and 171 (b), W will include $5,000 in her income for 1952. (The trustees will deduct $4,000 from the income of the trust under section 162.) H will not include any part of the $5,000 in his income nor take a deduction therefor. If H had paid the $1,000 to W, rather than allowing the trustees to pay it out of corpus, he would have been entitled to a deduction of $1,000 under the provisions of section 23 (u).

(d) For other examples, see § 39.22 (k)-1.

§ 39.23 (v)-(x) *Statutory provisions; deductions from gross income; cross references; medical, dental, etc., expenses.*

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

(v) *Bond premium deduction.* In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

[Sec. 23 (v) as added by sec. 126 (a), Rev. Act 1942]

(w) *Deductions of estate, etc., on account of decedent's deductions.* (1) In the case of a person described in section 126 (b), the amount of the deductions in respect of a decedent to the extent allowed by such subsection.

(2) In the case of a person described in section 126 (a), the amount of the deductions in respect of a decedent to the extent allowed by section 126 (c).

[Sec. 23 (w) as added by sec. 134 (d), Rev. Act 1942]

(x) *Medical, dental, etc., expenses.* Expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent specified in section 25 (b) (3)—

(1) If neither the taxpayer nor his spouse has attained the age of 65 before the close of the taxable year, to the extent that such expenses exceed 5 per centum of the adjusted gross income; or

(2) If either the taxpayer or his spouse has attained the age of 65 before the close of the taxable year, (A) the amount of such expenses for the care of the taxpayer and his spouse, and (B) the amount by which such expenses for the care of such dependents exceed 5 per centum of the adjusted gross income.

The deduction under this subsection shall not be in excess of $1,250 multiplied by the number of exemptions allowed under section 25 (b) for the taxable year (exclusive of exemptions allowed under section 25 (b) (1) (B) or (C), with a maximum deduction of $2,500, except that the maximum deduction shall be $5,000 in the case of a joint return of husband and wife under section 51 (b). The term "medical care", as used in this subsection, shall include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance). The determination of whether an individual is married at any time during the taxable year shall be made in accordance with the provisions of section 51 (b) (5).

[Sec. 23 (x) as added by sec. 127 (a), Rev. Act 1942; amended by sec. 8 (c), Individual Income Tax Act 1944; sec. 102 (b) (1), Rev. Act 1945; sec. 304, Rev. Act 1948; sec. 307 (a), Rev. Act 1951]

§ 39.23 (x)-1 *Medical, dental, etc., expenses.* (a) Section 23 (x) permits a deduction from gross income of payments for certain medical expenses. The deduction is allowable only to individuals and only with respect to medical expenses actually paid during the taxable year, regardless of when the incident or event which occasioned the expenses occurred and regardless of the method of accounting employed by the taxpayer in making his income tax return. If the medical expenses are incurred but not paid during the taxable year, no deduction can be taken for such year. Thus, if an expenditure was incurred in December 1952, but not paid until January 1953, no deduction may be taken for the year 1952.

(b) (1) Except as prescribed in paragraph (c) of this section, only such medical expenses are deductible as exceed 5 percent of the adjusted gross income for the taxable year. As to what constitutes adjusted gross income, see section 22 (n) The maximum deduction allowable for medical expenses paid in any one taxable year is $1,250 multiplied by the number of exemptions allowed under section 25 (b) (exclusive of exemptions allowed under section 25 (b) (1) (B) for a taxpayer or spouse attaining the age of 65 years or section 25 (b) (1) (C) for a blind taxpayer or blind spouse) but not in excess of $2,500 in the case of a single individual or a married individual making a separate return and not in excess of $5,000 in the case of a joint return of husband and wife.

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

Example. H and W make a joint return for the calendar year 1952, on which five exemptions are allowed (exclusive of exemptions under section 25 (b) (1) (B) or (C)), one for each taxpayer and three for their dependent minor children. The adjusted gross income of H and W in 1952 is $40,000. They pay during that year $9,000 for medical care, no part of which is compensated for by insurance or otherwise. The deduction allowable under section 23 (x) for the calendar year 1952 is $5,000, computed as follows:

Payment for medical care in 1952	$9,000
Less: 5 percent of $40,000 (adjusted gross income)	2,000
Excess of medical expenses in 1952 over 5 percent of adjusted gross income	7,000
Allowable deduction for 1952 ($1,250 multiplied by 5 exemptions allowed under section 25 (b) (1) (A) and (D) but not in excess of $5,000)	5,000

(c) (1) There is no five percent limitation on the deduction for medical expenses, not compensated for by insurance or otherwise, paid for the care of the taxpayer or his spouse, where either the taxpayer or his spouse has attained the age of 65 before the close of the taxable year. In such a case the taxpayer may deduct, subject to the maximum deduction allowable as described in paragraph (b) of this section, (i) the amount of all payments for the medical care of the taxpayer and his spouse; and (ii) the amount by which his payments for the medical care of his dependents exceeds 5 percent of his adjusted gross income. In determining the amount of medical expenses deductible under subdivision (ii) of this subparagraph, the amount deductible under subdivision (i) of this subparagraph shall not be taken into account for the purpose of computing the excess of medical expenses over the 5 percent limitation. In determining the age of an individual for the purpose of the unlimited deduction for medical expenses during old age, the last day of the taxable year of the taxpayer is the controlling date. Thus, a taxpayer who has not attained the age of 65 by the end of the taxable year may not claim the unlimited deduction with respect to payments made for the medical care of himself or his spouse if the spouse

dies before attaining the age of 65 even though such spouse, had she not died, would have attained the age of 65 before the close of the taxable year of the taxpayer.

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

Example (1). Taxpayer E, who attained the age of 65 years on February 22, 1952, makes his return on the basis of the calendar year. During the year 1952, E has adjusted gross income of $8,000, and pays the following medical bills: (a) $240 (3 percent of adjusted gross income) for the medical care of himself and his spouse, and (b) $320 (4 percent of adjusted gross income) for the medical care of his dependent son. The allowable deduction under section 23 (x) for 1952 is $240. No deduction is allowable for the amount of $320 paid for medical care of the dependent son since the amount of such payment (determined without regard to the payments for the care of the taxpayer and his spouse) does not exceed 5 percent of adjusted gross income.

Example (2). H and W make a joint return for the calendar year 1952 on which four exemptions are allowed (exclusive of exemptions under section 25 (b) (1) (B) or (C)), one for each taxpayer and two for their dependent minor children. W became 65 years of age on August 15, 1952. The adjusted gross income of H and W in 1952 is $40,000 and they pay in such year the following amounts for medical care: (a) $1,500 for the medical care of H; (b) $2,500 for the medical care of W; and (c) $3,500 for the medical care of the children. The allowable deduction under section 23 (x) for medical expenses paid in 1952 is $5,000 computed as follows:

Payment for medical care of H and W in 1952		$4,000
Payment for medical care of children in 1952	$3,500	
Less 5 percent of $40,000 (adjusted gross income)	2,000	
		1,500
		5,500
Maximum allowable deduction in 1952		5,000

(d) (1) The expenses paid must be for medical care of the taxpayer, his spouse, or a dependent of the taxpayer (see § 39.25-2 (e) for description of dependents) not compensated for by insurance or otherwise. The term "medical care" as used in this section and in section 23 (x) includes amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance) Payments for hospitalization insurance, or for membership in an association furnishing cooperative or so-called free-choice medical service, or group hospitalization and clinical care are amounts which may be deducted. Amounts paid for operations or treatments affecting any portion of the body, including obstetrical expenses and expenses of X-ray or therapy treatments, are deemed to be for the purpose of affecting any structure or function of the body and are therefore deductible. Amounts expended for illegal operations or treatments or illegally procured drugs are not deductible. Allowable deductions under section 23 (x) will be confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. Thus, payments for expenses for hospital, nursing (including nurses' board where paid by the taxpayer), medical, laboratory, surgical, dental and other diagnostic and healing services, for X-rays, for drugs and medical and dental supplies (including artificial teeth or limbs) and for ambulance hire and travel primarily for and essential to the rendition of the medical services or to the prevention or alleviation of a physical or mental defect or illness, are deductible.

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

Example. Taxpayer A, married to B and having one dependent child, had adjusted gross income for 1952 of $3,000. During 1952 he paid $300 for medical care, of which $100 was for treatment of his dependent child and $200 for an operation in September 1951, on B. In 1952 he received a payment of $50 for health insurance covering B's illness during 1951.

The deduction allowable under section 23 (x) for the calendar year 1952 is $100, computed as follows:

Payment for medical care in 1952	$300
Less: Amount of insurance received in 1952	50
Payment for medical care in 1952 not compensated for during 1952	250
Less: 5 percent of $3,000 (adjusted gross income)	150
Excess, allowable as a deduction for 1952	100

(e) (1) Where reimbursement, from insurance or otherwise, for medical expenses is not received until a taxable year subsequent to the year in which allowable medical expenses were paid, the reimbursement must be included in the gross income of the taxpayer for the taxable year in which the extent such reimbursement is received to the extent such reimbursement is attributable to (and not in excess of) deductions allowed under section 23 (x) for any prior taxable year (see section 22 (b) (5)) Where, during the year for which the deduction is taken, payments are made for medical care which are not compensated for during such year but for which compensation is received in a subsequent year or years, the entire amount of the compensation so received, if equal to or less than the amount which was deducted, shall be considered as attributable to the deduction taken for such prior year. If the amount of the compensation received in the subsequent year or years is greater than the amount which was deducted for the prior year, such portion of the compensation received which is equal in amount to the deduction taken shall be considered as attributable to such deduction. If the deduction for the prior year would have been greater but for the limitations on the maximum amount of such deduction provided by section 23 (x) (see paragraph (b) of this section) then, for purposes of the two preceding sentences, the amount of the compensation received in a subsequent year or years shall be reduced by an amount equal to the amount by which the deduction for the prior year would, but for the applicable maximum limitations, have been increased. If compensation is received in a subsequent year or years, the net deduction for medical expenses will thus be the same as if the compensation had been received in the year in which the payments for medical care were made.

(2) The deduction for medical expenses shall not be deemed to have been allowed for any taxable year for which the taxpayer claimed and was allowed the standard deduction under section 23 (aa)

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). Taxpayer C, a single individual with one dependent, is entitled to two exemptions under the provisions of section 25 (b). He had an adjusted gross income of $35,000 for the calendar year 1952. During 1952 he paid $9,000 for medical care. C received no compensation for such medical expenses in 1952, but in 1953 he receives $5,000 upon an insurance policy covering the medical expenses which he paid in 1952. C was allowed a deduction of $2,500 (the maximum) from his gross income for 1952. The amount which C must include in his gross income for 1953 is $250 and the amount to be excluded from gross income for 1953 is $4,750, computed as follows (see section 22 (b) (5))

Payment for medical care in 1952 (not compensated for in 1952)		$9,000
Less: 5 percent of $35,000 (adjusted gross income)		1,750
Excess of uncompensated medical expenses in 1952 over 5 percent of adjusted gross income		7,250
Allowable deduction for 1952		2,500
Amount by which the medical deduction for 1952 would have been greater than $2,500 but for the limitations on the maximum amount provided by section 23 (x)		4,750
Compensation received in 1953	$5,000	
Less: Amount by which the medical deduction for 1952 would have been greater than $2,500 but for the limitations on the maximum amount provided by section 23 (x)	4,750	
Compensation received in 1953 reduced by the amount by which the medical deduction for 1952 would have been greater than $2,500 but for the limitations on the maximum amount provided by section 23 (x)		250
Amount attributed to medical deduction taken for 1952		250
Amount to be included in gross income for 1953		250
Amount to be excluded from gross income for 1953 ($5,000 less $250)		4,750

Example (2). Assuming that C, in example (1), receives $8,000 in 1953 as compensation for the medical expenses which he paid in 1952, the amount which C must include in his gross income for 1953 is $2,500 and the amount to be excluded from gross income for 1953 is $5,500, computed as follows (see section 22 (b) (5))

Compensation received in 1953	$8,000
Less: Amount by which the medical deduction for 1952 would have been greater than $2,500 but for the limitations on the maximum amount provided by section 23 (x)	4,750
Compensation received in 1953 reduced by the amount by which the medical deduction for 1952 would have been greater than $2,500 but for the limitations on the maximum amount provided by section 23 (x)	3,250
Deduction allowable for 1952	2,500
Amount of compensation received in 1953 to be included in gross income for 1953 as attributable to deduction allowable for 1952	2,500
Amount to be excluded from gross income for 1953 ($8,000 less $2,500)	5,500

(f) In the case of medical expenses for the care of a person who is the taxpayer's spouse or dependent, the deduction under section 23 (x) is allowable if the status of such person as "spouse" or "dependent" of the taxpayer exists either at the time the expenses were incurred or at the time the payment of the expenses was made. Thus, payments made in June 1952, by A, for medical services rendered to B, his wife, in 1951 may be deducted by A for 1952 even though, before the payments were made, B died or secured a divorce; and payments made in July 1952, by C, for medical services rendered to D in 1951 may be deducted by C for 1952 even though C and D were not married until June 1952. However, the status of a person as the "spouse" of the taxpayer must exist as of the close of the taxable year of the taxpayer in which either the expenses were incurred or the payment was made, or, in the case of the death of the spouse in either such year, as of the time of such death. In determining whether such status exists a taxpayer who is legally separated from his spouse under a decree of separate maintenance is not considered as married.

(g) In connection with claims for deductions under section 23 (x) the taxpayer shall furnish the name and address of each person to whom payment for medical expenses was made and the amount and the approximate date of the actual payment thereof in each case. If payment was in kind, then such fact shall be so reflected. Claims for deductions must be substantiated, when requested by the Commissioner, by a statement from the individual or entity to which payment for medical expenses was made showing the nature of the service rendered, to or for whom rendered, the amount paid therefor, and the date of the actual payment thereof, and by such other information as the Commissioner may deem necessary.

§ 39.23 (y)-(z) *Statutory provisions; deductions from gross income; deduction for the blind; amounts representing taxes and interest paid to cooperative apartment corporation.*

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

(y) *Special deduction for blind individuals:* * * * [Repealed by section 202 (e), Rev. Act 1948, with respect to taxable years beginning after December 31, 1947.]

(z) *Amounts representing taxes and interest paid to cooperative apartment corporation*—(1) *In general.* In the case of a tenant-stockholder (as defined in paragraph (2)), amounts, not otherwise deductible, paid or accrued to a cooperative apartment corporation within the taxable year, if such amounts represent that proportion of the real estate taxes on the apartment building and the land on which it is situated, allowable as deductions under subsection (c), paid or incurred by the corporation, or of the interest paid or incurred by the corporation on its indebtedness contracted in the acquisition, construction, alteration, rehabilitation, or maintenance of such apartment building or in the acquisition of the land on which the building is located, which the stock of the corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation, including that held by the corporation.

(2) *Definition.* For the purposes of this subsection—

(A) *Cooperative apartment corporation.* The term "cooperative apartment corporation" means a corporation—

(i) Having one and only one class of stock outstanding,

(ii) All of the stockholders of which are entitled, solely by reason of their ownership of stock in the corporation, to occupy for dwelling purposes apartments in a building owned or leased by such corporation, and who are not entitled, either conditionally or unconditionally, except upon a complete or partial liquidation of the corporation, to receive any distribution not out of earnings and profits of the corporation, and

(iii) 80 per centum or more of the gross income of which for the taxable year in which the taxes and interest described in paragraph (1) are paid or incurred is derived from tenant-stockholders.

(B) *Tenant-stockholder.* The term "tenant-stockholder" means an individual who is a stockholder in a cooperative apartment corporation, and whose stock is fully paid-up in an amount not less than an amount shown to the satisfaction of the Commissioner as bearing a reasonable relationship to the portion of the value of the corporation's equity in the building and the land on which it is situated which is attributable to the apartment which such individual is entitled to occupy.

[Sec. 23 (z) as added by sec. 128, Rev. Act 1942]

§ 39.23 (z)-1 *Amounts representing taxes and interest paid to cooperative apartment corporation.* (a) A tenant-stockholder may deduct from his gross income amounts paid or accrued within his taxable year to a cooperative apartment corporation representing certain taxes or interest paid or incurred by such corporation. Such amounts are not allowable as a deduction unless they represent the tenant-stockholder's proportionate share of the real estate taxes on the apartment building and the land on which it is situated, allowable as deductions under section 23 (c), paid or incurred by the cooperative apartment corporation before the close of the taxable year of the tenant-stockholder, or of the interest paid or incurred by the corporation before such time on its indebtedness contracted in the acquisition, construction, alteration, rehabilitation, or maintenance of such apartment building or in the acquisition of the land on which the building is situated.

(b) The deduction allowable under section 23 (z) shall not exceed the amount of the tenant-stockholder's proportionate share of the taxes and interest described therein. In case a tenant-stockholder pays or incurs all or a part of his proportionate share of such taxes and interest to the corporation, the amount so paid or incurred representing taxes and interest is allowable as a deduction if the requirements of section 23 (z) are otherwise satisfied. As used in this section, the tenant-stockholder's proportionate share is that proportion which the stock of the cooperative apartment corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation, including that held by the corporation. If a tenant-stockholder pays or incurs to the corporation an amount on account of such taxes and interest and other items, such as maintenance, overhead expenses, and curtailment of mortgage indebtedness, the amount representing such taxes and interest is an amount which bears the same ratio to the total amount of the tenant-stockholder's payment or liability, as the case may be, as the total amount of the tenant-stockholder's proportionate share of such taxes and interest bears to the total amount of the tenant-stockholder's proportionate share of the taxes, interest, and other items on account of which such payment is made or liability incurred. No deduction is allowable under section 23 (z) for such part of amounts representing the taxes or interest described therein as is deductible by a tenant-stockholder under any other provision of the Internal Revenue Code.

(c) In order to qualify as a "cooperative apartment corporation" under section 23 (z), the corporation shall have only one class of stock outstanding. Each stockholder of the corporation shall be entitled to occupy for dwelling purposes an apartment in a building owned or leased by such corporation. The stockholder is not required to occupy the apartment. The right as against the corporation to occupy the apartment is sufficient. Such right shall be conferred on each stockholder solely by reason of his ownership of stock in the corporation, that is, the stock shall entitle the owner thereof either to occupy the apartment or to a lease of the apartment. The fact that the right to continue to occupy the apartment is dependent upon the payment of charges to the corporation in the nature of rentals or assessments is immaterial. None of the stockholders of the corporation shall be entitled, either conditionally or unconditionally, except upon a complete or partial liquidation of the corporation, to receive any distribution other than out of earnings or profits of the corporation. It is a prerequisite to the allowance of a deduction under section 23 (z) that at least 80 percent of the gross income of the corporation for the taxable year of the corporation in which the taxes and interest are paid or incurred is derived from tenant-stockholders.

(d) The term "tenant-stockholder" means an individual who is a stockholder

in a cooperative apartment corporation as defined in section 23 (z) and whose stock is fully paid up in an amount at least equal to an amount shown to the satisfaction of the Commissioner as bearing a reasonable relationship to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation's equity in the building and the land on which it is situated which is attributable to the apartment which such individual is entitled to occupy.

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

Example (1). The X Corporation is, and at all times since 1950 has been, a cooperative apartment corporation within the meaning of section 23 (z). In 1950 it purchased a site and constructed thereon a building with 10 apartments at a total cost of $200,000. The fair market value of the land and building was likewise $200,000 at the time of completion of the building. Each apartment is of equal value. Upon completion of the building, the X Corporation mortgaged the land and building for $100,000, and sold its total authorized capital stock, consisting of 1,000 shares of common stock, for $100,000. The stock was purchased by 10 individuals, each of whom paid $10,000 for 100 shares. Each certificate for 100 shares provides that the holder thereof is entitled to a lease of a particular apartment in the building for a specified term of years. Each lease provides that the lessee shall pay his proportionate part of the corporation's expenses. In 1950 the original owner of 100 shares of the common stock of the X Corporation and of the lease to apartment No. 1 made a gift of the stock and lease to A, an individual. The taxable year of A and of the X Corporation is the calendar year. The corporation computes its net income on the accrual basis, while A computes his net income on the cash receipts and disbursements basis. In 1951 the X Corporation incurred expenses aggregating $13,800, namely, $4,000 for the real estate taxes on the land and building, $5,000 for the interest on the mortgage, $3,000 for the maintenance of the building, and $1,800 for other expenses. In 1952, A pays the X Corporation $1,380, representing his proportionate part of the expenses incurred by the corporation. The entire gross income of the X Corporation for 1951 was derived from tenant-stockholders. A is entitled under section 23 (z) to a deduction of $900 in computing his net income for 1952. The deduction is computed as follows:

Shares of stock of X Corporation owned by A		100
Shares of stock of X Corporation owned by 9 other tenant-stockholders		900
Total shares of stock of X Corporation outstanding		1,000
Proportion of outstanding stock of X Corporation owned by A		1/10
Expenses incurred by X Corporation:		
Real estate taxes	$4,000	
Interest	5,000	
Maintenance	3,000	
Other expenses	1,800	
		$13,800
Amount paid by A representing his proportionate part of such expenses (1/10 of $13,800)		1,380
A's proportionate part of real estate taxes and interest based on his stock ownership (1/10 of $9,000)		900
A's proportionate part of total corporate expenses based on his stock ownership (1/10 of $13,800)		$1,380
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,380)		900
A's allowable deduction		900

Since the stock which A acquired by gift was fully paid up by his donor in an amount equal to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation's equity in the land and building which is attributable to apartment No. 1, the requirement of section 23 (z) in this regard is satisfied. The fair market value at the time of the gift of the corporation's equity attributable to the apartment is immaterial.

Example (2). The facts are the same as in example (1) except that the building constructed by the X Corporation contained, in addition to the 10 apartments, business space on the ground floor, which the corporation rented at $2,400 for the calendar year 1951; the corporation deducted the $2,400 from its expenses in determining the amount of the expenses to be prorated among its tenant-stockholders; the amount paid by A to the corporation in 1952 is $1,140 instead of $1,380; and more than 80 percent of the gross income of the corporation for 1951 was derived from tenant-stockholders. A is entitled under section 23 (z) to a deduction of $743.48 in computing his net income for 1952. The deduction is computed as follows:

Expenses incurred by X Corporation	$13,800.00
Less rent from business space	2,400.00
Expenses to be prorated among tenant-stockholders	11,400.00
Amount paid by A representing his proportionate part of such expenses (1/10 of $11,400)	1,140.00
A's proportionate part of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	900.00
A's proportionate part of total corporate expenses based on his stock ownership (1/10 of $13,800)	1,380.00
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,140)	743.48
A's allowable deduction	743.48

Since the portion of A's payment allocable to real estate taxes and interest is only $743.48, that amount instead of $900 is allowable as a deduction in computing A's net income for 1952.

Example (3). The facts are the same as in example (2) except that the amount paid by A to the X Corporation in 1952 is $1,000 instead of $1,140. A is entitled under section 23 (z) to a deduction of $652.17 in computing his net income for 1952. The deduction is computed as follows:

Total amount paid by A	$1,000.00
A's proportionate part of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	900.00
A's proportionate part of total corporate expenses based on his stock ownership (1/10 of $13,800)	1,380.00
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,000)	652.17
A's allowable deduction	652.17

Since the portion of A's payment allocable to real estate taxes and interest is only $652.17, that amount instead of $900 is allowable as a deduction in computing A's net income for 1952.

§ 39.23 (aa) *Statutory provisions; deductions from gross income; optional standard deduction for individuals.*

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

(aa) *Optional standard deduction for individuals*—(1) *Allowance.* In the case of an individual, at his election a standard deduction as follows:

(A) *Adjusted gross income $5,000 or more.* If his adjusted gross income is $5,000 or more, the standard deduction shall be $1,000 or an amount equal to 10 per centum of the adjusted gross income, whichever is the lesser, except that in the case of a separate return by a married individual, the standard deduction shall be $500.

(B) *Adjusted gross income less than $5,000.* If his adjusted gross income is less than $5,000, the standard deduction shall be an amount equal to 10 per centum of the adjusted gross income upon the basis of which the tax applicable to the adjusted gross income of the taxpayer is determined under the tax table provided in section 400.

(2) *In lieu of certain deductions and credits.* The standard deduction shall be in lieu of: (A) all deductions other than those which under section 22 (n) are to be subtracted from gross income in computing adjusted gross income, (B) all credits with respect to taxes of foreign countries and possessions of the United States, (C) all credits with respect to taxes withheld at the source under section 143 (a) (relating to interest on tax-free covenant bonds), and (D) all credits against net income with respect to interest on certain obligations of the United States and Government corporations of the character specified in section 25 (a) (1) and (2).

(3) *Method and effect of election.* (A) If the adjusted gross income shown on the return is $5,000 or more, the standard deduction shall be allowed if the taxpayer so elects in his return, and the Commissioner, with the approval of the Secretary, shall by regulations prescribe the manner of signifying such election in the return.

(B) If the adjusted gross income shown on the return is less than $5,000, the standard deduction shall be allowed if the taxpayer elects, in the manner provided in Supplement T, to pay the tax imposed by such supplement.

(C) If the taxpayer upon making his return fails to signify, in the manner provided by subparagraph (A) or (B), his election to take the standard deduction, such failure shall be considered his election not to take the standard deduction.

(D) If the adjusted gross income shown on the return is $5,000 or more, but the correct adjusted gross income is less than $5,000, then an election by the taxpayer under subparagraph (A) to take the standard deduction shall be considered as his election to pay the tax imposed by Supplement T; and his failure to make under subparagraph (A) an election to take the standard deduction shall be considered his election not to pay the tax imposed by Supplement T. If the adjusted gross income shown on the return is less than $5,000, but the correct adjusted gross income is $5,000 or more, then an election by the taxpayer under subparagraph (B) to pay the tax imposed by Supplement T shall be considered as his election to take the standard deduction; and his failure to elect under subparagraph (B) to pay the tax imposed by Supplement T shall be considered his election not to take the standard deduction.

(4) *Husband and wife.* In the case of husband and wife, the standard deduction shall not be allowed to either if the net income of one of the spouses is determined without regard to the standard deduction.

(5) *Short period.* In the case of a taxable year of less than twelve months on account of a change in the accounting period, the standard deduction shall not be allowed.

(6) *Determination of status.* For the purposes of this subsection—

(A) The determination of whether an individual is married shall be made as of the close of his taxable year, unless his spouse dies during his taxable year, in which case such determination shall be made as of the time of such death; and

(B) An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

(7) *Change of election.* Under regulations prescribed by the Secretary, a change of an election to take, or not to take, the standard deduction for any taxable year may be made after the filing of the return for such year. If the spouse of the taxpayer filed a separate return for any taxable year corresponding, for the purposes of paragraph (4), to the taxable year of the taxpayer, the change shall not be allowed unless, in accordance with such regulations—

(A) The spouse makes a change of election with respect to the standard deduction for the taxable year covered in such separate return, consistent with the change of election sought by the taxpayer, and

(B) The taxpayer and his spouse consent in writing to the assessment, within such period as may be agreed upon with the Secretary, of any deficiency, to the extent attributable to such change of election, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

This paragraph shall not apply if the tax liability of the taxpayer's spouse, for the taxable year corresponding (for the purposes of paragraph (4) to the taxable year of the taxpayer, has been compromised under the provisions of section 3761.

[Sec. 23 (aa) as added by sec. 9 (a), Individual Income Tax Act 1944, amended by sec. 302, Rev. Act 1948 and sec. 308 (a), (b), Rev. Act. 1951]

§ 39.23 (aa)-1 *Standard deduction*—(a) *General.* (1) The taxpayer may elect to take, in addition to the deductions from gross income allowable in computing adjusted gross income, a standard deduction in lieu of all nonbusiness deductions (that is, deductions other than those allowable under section 22 (n)) and in lieu of certain credits allowable to the taxpayer had he not so elected. Such credits are the credit provided by sections 31 and 131 for income tax paid to foreign countries or possessions of the United States, the credit provided by section 32 for tax paid at the source under section 143 (a) by the obligor on tax-free covenant bonds with respect to interest on such bonds, and the credit provided by section 25 (a) (1) and (2) for normal-tax purposes with respect to interest on United States obligations and interest on obligations of instrumentalities of the United States.

(2) In the case of taxpayers whose adjusted gross income is $5,000 or more, the standard deduction is $1,000 or 10 percent of adjusted gross income, whichever is the lesser, except that in the case of a separate return by a married individual, the standard deduction is $500. For the purpose of the preceding sentence, the determination of whether an individual is married shall be made as of the close of his taxable year unless his spouse dies during his taxable year, in which case such determination shall be made as of the time of such death; and an individual shall be considered as married even though living apart from his spouse unless legally separated under a decree of divorce or separate maintenance. In the case of taxpayers whose adjusted gross income is less than $5,000, the standard deduction is about 10 percent of the adjusted gross income upon which the tax is determined in the table provided in section 400. A taxpayer having adjusted gross income of less than $5,000, who does not elect to pay the tax imposed by Supplement T, may not take the standard deduction.

(3) In the case of a joint return, there is only one adjusted gross income and only one standard deduction. For example, if a husband has an income of $15,000 and his spouse has an income of $12,000 for the taxable year for which they file a joint return, and they have no deductions allowable for the purpose of computing adjusted gross income, the adjusted gross income is $27,000, and the standard deduction is $1,000 (and not $2,000)

(4) The standard deduction is not allowable:

(i) In the case of a taxable year of less than 12 months where such taxable year arises because of a change in accounting period under section 47 (a)

(ii) In the case of a return for a fractional part of a year under section 146 (a) (1)

(iii) In the case of an estate or trust;

(iv) In the case of common trust funds;

(v) In the determination of the net income of a partnership;

(vi) In the case of nonresident alien individuals (including those who enter and leave the United States at frequent intervals) and

(vii) In the case of a citizen of the United States entitled to the benefits of section 251.

(5) An election to take the standard deduction is not precluded by reason of the fact that the return is made for a taxable year of less than 12 months on account of the death of the taxpayer.

(b) *Manner and effect of election to take the standard deduction.* The following rules are prescribed with respect to the manner of signifying an election by a taxpayer to take the standard deduction:

(1) A taxpayer whose adjusted gross income as shown by his return is $5,000 or more shall be allowed the standard deduction if he signifies on his return his election to take such deduction. Such taxpayer shall so signify on his return by claiming thereon the deduction in the amount provided for in section 23 (aa) instead of itemizing the deductions allowable under section 23 other than those specified in section 22 (n). The amount to be claimed on the return by such taxpayer is $1,000 or 10 percent of the adjusted gross income, whichever is lesser (except that in the case of a separate return by a married individual, the amount is $500). If in any case the adjusted gross income shown on the return of the taxpayer is $5,000 or more, but the correct adjusted gross income is less than $5,000, then:

(i) If the taxpayer has elected on his return to take the standard deduction such election shall be deemed to be an election by the taxpayer to pay the tax imposed by Supplement T; and

(ii) If the taxpayer has not so elected upon his return, it shall be deemed that the taxpayer has elected not to pay the tax under Supplement T.

(2) If the adjusted gross income shown on the return is less than $5,000, the standard deduction is allowable if the taxpayer elects in the manner provided in Supplement T to pay the tax imposed by such supplement. As to the manner and effect of election to pay the tax under Supplement T, see § 39.402-1. In any case, however, in which adjusted gross income shown on the return is less than $5,000 but the correct adjusted gross income is in fact $5,000 or more, then:

(i) If the taxpayer has elected to pay the tax imposed under Supplement T, it shall be deemed that he has elected to take the standard deductions; and

(ii) If the taxpayer has not elected on his return to pay the tax under Supplement T, it shall be deemed that he has made an election not to take the standard deduction.

(c) *Husband and wife.* (1) In the case of husband and wife (except as qualified below), if the net income of one spouse is determined without regard to the standard deduction, the other spouse may not elect to take the standard deduction. If a joint return is filed and election made thereon to take the standard deduction, such deduction shall be determined by reference to the aggregate adjusted gross income of both spouses. If Form 1040A is filed as a combined return, the standard deduction is allowed through the application to the adjusted gross income shown on such return of the tax table in Supplement T. See § 39.51-2 limiting the use of Form 1040A as a combined return to cases in which the aggregate adjusted gross income of the spouses is less than $5,000.

(2) If each spouse files Form 1040, both must elect to take the standard deduction or both are denied the standard deduction. If one spouse files Form 1040 and does not elect to take the standard deduction, the other spouse may not elect to take the standard deduction and, hence, may not file Form 1040A as his or her return. Thus, if A and his wife B have adjusted gross incomes of $6,000 and $3,500 from wages subject to withholding, respectively, and A files Form 1040 and does not elect thereon to take the standard deduction, B may not file Form 1040A but must file Form 1040, taking thereon only her actual allowable deductions and not the standard deduction. In such case, however, if both elect to take the standard deduction, A must file Form 1040, but B may file Form 1040A or, in the alternative, she may file Form 1040 and compute the tax under Supplement T. Under either alternative, effect is given to the standard deduction through the application of Supplement T.

(3) The restriction upon the right of a married person to elect the standard deduction in his separate return is applicable with respect to the taxable years of the husband and wife ending in the same calendar year, except that in the event of the death of one spouse the restriction is applicable with respect to the taxable year ended with death and the taxable year of the surviving spouse in which such death occurs. The restriction applies unless the spouses are legally separated under a decree of divorce or separate maintenance. The determination of whether an individual is married (whether or not living with his spouse) for the purpose of the allowance of the standard deduction shall be made as of the last day of such individual's taxable year, unless his spouse dies during such taxable year, in which event the determination shall be made as of the date of the death of such spouse.

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

Example (1). Taxpayer A and his wife B both make their returns on a calendar year basis. In July 1952 they enter into a separation agreement and thereafter live apart but no decree of divorce or separate maintenance is issued until March 1953. If A itemizes and claims his actual deductions on his return for the calendar year 1952, B may not elect the standard deduction on her return for such year since B is considered as married to A (although permanently separated by agreement) on the last day of 1952.

Example (2). Taxpayer A makes his returns on the basis of a fiscal year ending June 30. His wife B makes her returns on the calendar year basis. A died in October 1952. In such case, since A and B were married as of the date of death, B may not elect the standard deduction for the calendar year 1952 if the income of A for the short taxable year ending with the date of his death is determined without regard to the standard deduction.

(d) *Change of election to take, or not to take, the standard deduction.* (1) A change of the election to take, or not to take, the standard deduction for any taxable year may be made before or after the time prescribed for filing the return for the taxable year. However, the period of time prescribed in section 322 within which claim for credit or refund of tax must be made is not extended by the right to effect a change of election. See § 39.322-7.

(2) If the spouse of the taxpayer filed a separate return for any taxable year that corresponds, for the purpose of section 23 (aa) (4) (see paragraph (c) of this section) to the taxable year of the taxpayer, a change of election may not be made by the taxpayer unless (i) the spouse makes a change of election in such separate return with respect to the standard deduction consistent with the change of election sought by the taxpayer, and (ii) the taxpayer and his spouse file a consent in writing to the assessment, within such period of time as may be agreed upon, of any deficiency of either to the extent attributable to such change of election even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

(3) A change of election for any taxable year shall not be permitted if the tax liability of the taxpayer for the taxable year, or of the taxpayer's spouse for the taxable year corresponding, for the purpose of section 23 (aa) (4) (see paragraph (c) of this section) to the taxable year of the taxpayer, has been compromised under the provisions of section 3761.

§ 39.23 (bb) *Statutory provisions; deductions from gross income; circulation expenditures.*

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

(bb) *Circulation expenditures.* Notwithstanding section 24 (a), all expenditures (other than expenditures for the purchase of land or depreciable property or for the acquisition of circulation through the purchase of any part of the business of another publisher of a newspaper, magazine, or other periodical) to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical; except that the deduction shall not be allowed with respect to the portion of such expenditures as, under regulations prescribed by the Secretary, is chargeable to capital account if the taxpayer elects, in accordance with such regulations, to treat such portion as so chargeable. Such election, if made, must be for the total amount of such portion of the expenditures which is so chargeable to capital account; and shall be binding for all subsequent taxable years unless, upon application by the taxpayer, the Secretary permits a revocation of such election subject to such conditions as he deems necessary.

[Sec. 23 (bb) as added by sec. 204 (a), Rev. Act 1950]

§ 39.23 (bb)-1 *Circulation expenditures*—(a) *Allowance of deduction.* Section 23 (bb) provides for the deduction from gross income (notwithstanding the provisions of section 24 (a) and the regulations thereunder, relating to items not deductible from gross income) of all expenditures to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical subject to the two following rules:

(1) The deduction is not allowable with respect to expenditures for the purchase of land or depreciable property or for the acquisition of circulation through the purchase of any part of the business of another publisher of a newspaper, magazine, or other periodical.

(2) The deduction is allowable only to the publisher making the circulation expenditures.

(b) *Election to capitalize.* A taxpayer entitled to the deduction for circulation expenditures provided in section 23 (bb) may, in lieu of taking such deduction, elect to charge to capital account the portion of such circulation expenditures which, under approved standard methods of accounting, is properly chargeable to capital account. As a general rule, expenditures normally made from year to year in an effort to maintain circulation are not properly chargeable to capital account; however, expenditures made in an effort to establish or to increase circulation are properly chargeable to capital account. For example, if a newspaper normally employs five persons to obtain renewals of subscriptions by telephone, the expenditures in connection therewith would not be properly chargeable to capital account. However, if such newspaper, in a special effort to increase its circulation, hires for a limited period 20 additional employees to obtain new subscriptions by means of telephone calls to the general public, the expenditures in connection therewith would be properly chargeable to capital account. If an election is made by the taxpayer to treat any portion of his circulation expenditures as chargeable to capital account, such election must be for the total amount of all such expenditures which are properly so chargeable; in such case, no deduction will be allowed for any such expenditures which are properly chargeable to capital account. If such election is made with respect to a particular taxable year, the taxpayer must continue for subsequent taxable years to charge to capital account all circulation expenditures which are properly so chargeable, unless the Commissioner, on application in writing made to him by the taxpayer, permits a revocation of such election with respect to any subsequent taxable year, subject to such conditions as the Commissioner deems necessary. The election referred to in this paragraph shall be made by a statement attached to the taxpayer's return for the first taxable year to which such election is applicable.

§ 39.23 (cc) *Statutory provisions; deductions from gross income; deduction of expenditures paid or incurred for the development of mines or other natural deposits.*

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

(cc) *Development of mines*—(1) *In general.* Except as provided in paragraph (2), all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after December 31, 1950, and after the existence of ores or minerals in commercially marketable quantities has been disclosed. This subsection shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 23 (l), but allowances for depreciation shall be considered, for the purposes of this subsection, as expenditures.

(2) *Election of taxpayer.* At the election of the taxpayer, made in accordance with regulations prescribed by the Secretary, expenditures described in paragraph (1) paid or incurred during the taxable year shall be treated as deferred expenses and shall be deductible on a ratable basis as the units of produced ores or minerals benefited by such expenditures are sold. In the case of such expenditures paid or incurred during the development stage of the mine or deposit, the election shall apply only with respect to the excess of such expenditures during the taxable year over the net receipts during the taxable year from the ores or minerals produced from such mine or deposit. The election under this paragraph, if made, must be for the total amount of such expenditures, or the total amount of such excess, as the case may be, with respect to the mine or

deposit, and shall be binding for such taxable year.

(3) *Adjusted basis of mine or deposit.* The amount of expenditures which are treated under paragraph (2) as deferred expenses shall be taken into account in computing the adjusted basis of the mine or deposit, except that such amount, and the adjustments to basis provided in section 113 (b) (1) (J), shall be disregarded in determining the adjusted basis of the property for the purpose of computing a deduction for depletion under section 114.

[Sec. 23 (cc) as added by sec. 309 (a), Rev. Act 1951]

§ 39.23 (cc)-1 *Mine development expenditures*—(a) *Allowance of deduction.* (1) Section 23 (cc) (1) provides for a deduction from gross income of all expenditures for the development of a mine or other natural deposit (other than an oil or gas well) paid or incurred by the taxpayer after the existence of ores or minerals in commercially marketable quantities has been disclosed subject to the following rules. The deduction is not allowable with respect to expenditures for the acquisition or improvement of property of a character subject to allowance for depreciation under section 23 (l) However, allowances for depreciation shall be considered for the purposes of this section as expenditures for development to the extent allocable to development. Such development expenditures are deductible under section 23 (cc) (1) (notwithstanding the provisions of § 39.23 (m)-15) whether paid or incurred by the taxpayer while the mine or deposit is in the development or while in the production stage.

(2) For the purposes of this section, expenditures thus described include only those which, except for this section, would not qualify as a deduction for the taxable year. For treatment of certain exploration expenditures, see section 23 (ff) and § 39.23 (ff)-1. In general, the provisions of this section are applicable only to costs paid or incurred by the taxpayer in respect of development undertaken (directly or through a contract) by the taxpayer and do not apply, for example, to such costs of development undertaken by other persons as may be reflected in the acquisition cost paid or incurred by the taxpayer for wholly or partially developed property.

(3) As to the deductibility of expenditures attributable to a grant or loan made to a taxpayer by the United States for the encouragement of the exploration, development, or mining of critical and strategic minerals, see section 22 (b) (15)

(b) *Election to defer* (1) A taxpayer entitled to the deduction under section 23 (cc) (1) may, in lieu of taking such deduction in the year when the expenditures for development were paid or incurred, elect under section 23 (cc) (2) to treat such expenditures as deferred expenses to be deducted ratably as the units of the produced ore or minerals benefited by the expenditures are sold. In the case of such expenditures paid or incurred while the mine or deposit is in the development stage, the election is applicable only in respect of the excess of such expenditures paid or incurred during the taxable year over the net receipts during the taxable year from the ore or minerals produced from the mine or deposit. The amount of such expenditures not in excess of net receipts from the ore or mineral for the taxable year while the mine or deposit is in the development stage shall be deductible in full. See § 39.23 (m)-15 (a) for description as to when a mine will be considered to have passed from a development to a production stage.

(2) The amount of the deduction allowable during the taxable year is an amount A, which bears the same ratio to B (the total deferred development expenditures for a particular mine or deposit reduced by the amount of such expenditures deducted in prior taxable years) as C (the number of units of the ore or mineral benefited by such expenditures sold during the taxable year) bears to D (the number of units of ore or mineral benefited by such expenditures remaining as of the taxable year) For the purposes of this proportion, the "number of units of ore or mineral benefited by such expenditures remaining as of the taxable year" is the number of units of ore or mineral benefited by the deferred development expenditures remaining at the end of the year to be recovered from the mine or deposit (including units benefited by such expenditures recovered but not sold) plus the number of units benefited by such expenditures sold within the taxable year. The principles outlined in § 39.23 (m)-9 are applicable in estimating the number of units remaining as of the taxable year and the number of units sold during the taxable year. The estimate is subject to revision in accordance with that section in the event it is ascertained as the result of operations or development that the remaining units are materially greater or less than the number of units remaining from a prior estimate. Sections 39.23 (e)-3 and 39.23 (f)-1 contain rules relating to the treatment of losses resulting from abandonment.

(3) If the taxpayer has paid or incurred expenditures of the character described herein, has made the election to defer such expenditures, and thereafter leases the developed property retaining a royalty interest therein, he shall be allowed the ratable deduction indicated in subparagraph (2) of this paragraph.

(4) The election referred to in this paragraph shall be made for each mine or deposit by a clear indication on the return or by a statement filed with the district director of internal revenue with whom the return was filed not later than six months after the filing of the return for the taxable year to which such election is applicable, or, in case the return for the taxable year to which such election is applicable is filed on or before March 15, 1953, by a statement in writing to that effect filed with the district director of internal revenue with whom the return was filed on or before September 15, 1953. If such an election is made by the taxpayer, such election must be for the total amount of all such expenditures during the taxable year while the mine or deposit is in the producing stage. If the mine or deposit is in the development stage, such election must be for all of the excess of such expenditures over the net receipts during the taxable year from the ore or mineral produced. The election shall be binding for the taxable year with respect to which the election was made.

§ 39.23 (dd) *Statutory provisions; deductions from gross income; repayment by mutual savings banks, etc., of certain loans.*

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

(dd) *Repayment by mutual savings banks, etc., of certain loans.* In the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, amounts paid by the taxpayer during the taxable year in repayment of loans made prior to September 1, 1951, by (1) the United States or any agency or instrumentality thereof which is wholly owned by the United States, or (2) any mutual fund established under the authority of the laws of any State.

[Sec. 23 (dd) as added by sec. 313 (g), Rev. Act 1951]

§ 39.23 (dd)-1 *Repayment of certain loans by mutual savings banks, building and loan associations, and cooperative banks.* There is deductible, under section 23 (dd) from the gross income of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, amounts paid by such institutions during the taxable year in repayment of loans made before September 1, 1951, by the United States or any agency or instrumentality thereof which is wholly owned by the United States, and amounts paid to a mutual fund established under the authority of the laws of any State. For example, amounts paid by such institution in repayment of loans made by the Reconstruction Finance Corporation before September 1, 1951, are deductible under this section. Section 23 (dd) is not applicable, however, in the case of amounts paid to an agency or instrumentality not wholly owned by the United States.

§ 39.23 (ee)-(ff) *Statutory provisions; deductions from gross income; cross reference; exploration expenditures.*

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

(ee) *Long-term capital gains.* In the case of a taxpayer other than a corporation, the deduction for long-term capital gains provided in section 117 (b).

[Sec. 23 (ee) as added by sec. 322, Rev. Act 1951]

(ff) *Deduction of exploration expenditures*—(1) *In general.* In the case of expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, and paid or incurred prior to the beginning of the de-

velopment stage of the mine or deposit, so much of such expenditures as does not exceed $75,000. This subsection shall apply only with respect to the amount of such expenditures which, but for this subsection, would not be allowable as a deduction for the taxable year. This subsection shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 23 (l), but allowances for depreciation shall be considered, for the purposes of this subsection, as expenditures paid or incurred. In no case shall this subsection apply with respect to amounts paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of oil or gas.

(2) *Election of taxpayer.* If the taxpayer elects, in accordance with regulations prescribed by the Secretary, to treat as deferred expenses any portion of the amount deductible for the taxable year under paragraph (1), such portion shall not be deductible under paragraph (1) but shall be deductible on a ratable basis as the units of produced ores or minerals discovered or explored by reason of such expenditures are sold. An election made under this paragraph for any taxable year shall be binding for such year.

(3) *Limitation.* This subsection shall not apply to any amounts paid or incurred in any taxable year if in any four preceding years the taxpayer, or any individual or corporation who has transferred to the taxpayer any mineral property under circumstances which make the provisions of paragraph (7), (8), (11), (13), (15), (17), (20), or (22) of section 113 (a) applicable to such transfer, has either (A) been allowed a deduction under paragraph (1) of this subsection or (B) made the election provided under paragraph (2) of this subsection.

(4) *Adjusted basis of mine or deposit.* The amount of expenditures which are treated under paragraph (2) as deferred expenses shall be taken into account in computing the adjusted basis of the mine or deposit, but such amounts, and the adjustments to basis provided in section 113 (b) (1) (M) shall be disregarded in determining the adjusted basis of the property for the purpose of computing a deduction for depletion under section 114.

[Sec. 23 (ff), as added by sec. 342 (a), Rev. Act 951]

§ 39.23 (ff)–1 *Discovery or exploration expenditures*—(a) *Allowance of deduction.* (1) Subject to the limitation prescribed in paragraph (c) of this section, section 23 (ff) (1) provides for a deduction from gross income of expenditures for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (other than oil or gas) paid or incurred by the taxpayer before the beginning of the development stage. The expenditures thus described include only those which, except for this section, would not qualify as a deduction for the taxable year and do not include expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided for in section 23 (l) However, allowances for depreciation shall be considered for the purposes of this section as expenditures paid or incurred. For the purposes of this section, such expenditures do not include expenditures paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed. For treatment of development expenditures see section 23 (cc) and § 39.23 (cc)–1. In general, the provisions of this section are applicable only to costs paid or incurred by the taxpayer in respect of exploration or discovery undertaken (directly or through contract) by the taxpayer and do not apply, for example, to such costs of exploration or discovery undertaken by other persons as may be reflected in the acquisition cost paid or incurred by the taxpayer for the property.

(2) As to the deductibility of expenditures attributable to a grant or loan made to a taxpayer by the United States for the encouragement of the exploration, development or mining of critical and strategic minerals, see section 22 (b) (15)

(b) *Election to defer* (1) A taxpayer entitled to the deduction under section 23 (ff) (1) may, in lieu of taking such deduction to which he is entitled in the year when the expenditures for discovery or exploration were paid or incurred, elect under section 23 (ff) (2) to treat any portion of such deductible expenditures as deferred expenses to be deducted ratably as the units of produced ores or minerals discovered or explored by reason of such expenditures are sold.

(2) The amount of the deduction allowable during the taxable year is an amount A, which bears the same ratio to B (the total deferred discovery or exploration expenditures reduced by the amount of such expenditures deducted in prior taxable years) as C (the number of units of the produced ore or mineral sold during the taxable year) bears to D (the number of units of ore or mineral remaining as of the taxable year) For the purposes of this proportion, the "number of units of ore or mineral remaining as of the taxable year" is the number of units of ore or mineral remaining at the end of the year to be recovered from the mines or deposits benefited by such expenditures (including units recovered but not sold) plus the number of units sold within the taxable year. The principles outlined in § 39.23 (m)–9 are applicable in estimating the number of units remaining as of the taxable year and the number of units sold during the year. The estimate is subject to revision in accordance with that section in the event it is ascertained as the result of further discovery, development or operations that the remaining units are materially greater or less than the units remaining from a prior estimate. Sections 39.23 (e)–3 and 39.23 (f)–1 contain rules relating to the treatment of losses resulting from abandonment.

(3) If the taxpayer has paid or incurred expenditures of the character described herein, has made the election to defer such expenditures and thereafter leases the mine or deposit benefited by such expenditures retaining a royalty interest therein, he shall be allowed the ratable deduction indicated in subparagraph (2) of this paragraph.

(4) The election referred to in this paragraph shall be made by a clear indication on the return or by a statement filed with the district director of internal revenue with whom the return was filed not later than six months after the filing of the return for the taxable year to which such election is applicable, or, in case the return for the taxable year to which such election is applicable is filed on or before March 15, 1953, by a statement in writing to that effect filed with the district director of internal revenue with whom the return was filed on or before September 15, 1953. In such statement, the taxpayer shall disclose the amount to be deferred, and the name, location, extent and nature of the mineral deposit to which the election relates. The election shall be binding for the taxable year with respect to which the election was made.

(c) *Limitation.* The deduction described in paragraph (a) of this section is allowable only for the amount of all such expenditures paid or incurred by the taxpayer in the taxable year as does not exceed $75,000. Amounts otherwise allowable as deductions without reference to this section (except allowances for depreciation) are not to be taken into account in determining this limitation. The limitation applies to all such described expenditures of the taxpayer and is not a total amount allowable with respect to each mine or deposit. No deduction under section 23 (ff) (1) or election under section 23 (ff) (2) may be taken or exercised if in any four preceding years (not necessarily consecutive years) the taxpayer, or any individual or corporation who has transferred to the taxpayer any mineral or ore property under circumstances which make the provisions of paragraph (7), (8), (11) (13) (15) (17) (20), or (22) of section 113 (a) applicable to such transfer, has been allowed a deduction or elected to treat such expenditures as deferred expenses under section 23 (ff) (1) or section 23 (ff) (2) respectively. Thus, under such circumstances, no deduction under section 23 (ff) (1) or election under section 23 (ff) (2) may be taken or exercised after the combined deductions and elections so taken or exercised by one or more transferors and the taxpayer equal four. For the purpose of the preceding sentence, a deduction and an election availed of in any taxable year by a particular taxpayer or transferor shall be considered as having been taken or exercised only once.

Example (1). Assume that a taxpayer who has never claimed the benefits of section 23 (ff) received in 1956 a mineral deposit from X corporation upon a distribution in complete liquidation of the latter under conditions which would make the provisions of section 113 (a) (15) applicable in determining the basis of the property in the hands of the taxpayer, and that during the year 1955 X corporation expended $60,000 for exploration expenditures which X corporation elected to treat as deferred expenses. On the basis of these facts the taxpayer may deduct or defer for any three (not necessarily consecutive) subsequent taxable years similar expenditures made in those years not to exceed $75,000 in any year. Where the amount expended in any taxable year is less than $75,000 the difference, if any, may not be carried over or back to other taxable years.

Example (2). Assume the same facts stated in example (1) except that, prior to acquisition by the taxpayer of the deposit from corporation X in 1956, corporation X

had acquired the deposit in 1954 in a similar distribution from Y corporation which, in the years 1952 and 1953, deducted exploration costs paid in respect of an entirely different deposit in the amounts of $30,000 and $50,000 respectively. Under these circumstances, the taxpayer may deduct or defer exploration expenditures paid or incurred for only one taxable year in an amount not in excess of $75,000.

§ 39.24 (a) *Statutory provisions; items not deductible; in general.*

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, except extraordinary medical expenses deductible under section 23 (x);

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, except expenditures for the development of mines or deposits deductible under section 23 (cc);

(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;

(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 chapter, or any amount otherwise allowable under section 23 (a) (2) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this chapter;

(6) Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid within a period of four years from the date on which such contract is purchased, such contract shall be considered a single premium life insurance or endowment contract; or

(7) Amounts paid or accrued for such taxes and carrying charges as, under regulations prescribed by the Commissioner with the approval of the Secretary, are chargeable to capital account with respect to property, if the taxpayer elects, in accordance with such regulations, to treat such taxes or charges as so chargeable.

[Sec. 24 (a) as amended by secs. 121 (b), 127 (b), 129, 130 (a), Rev. Act 1942; sec. 309 (c), Rev. Act 1951]

§ 39.24 (a)-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 and attorneys' fees and other costs of suit to recover such damages are not deductible. Generally, attorneys' fees paid in a suit for divorce or separate maintenance are not deductible. However, the part of an attorney's fee paid in a divorce or separate maintenance proceeding which is properly attributable to the production or collection of amounts includible in gross income under section 22 (k) is deductible under section 23 (a) (2). Amounts paid as alimony or allowance for support upon divorce or separation are not deductible except as provided in section 23 (u) 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. For deduction of extraordinary medical expenses (including amounts paid for accident or health insurance) see section 23 (x)

§ 39.24 (a)-2 *Capital expenditures*—(a) *Expenditures except non-depreciable mine development 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 are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense. 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 § 39.22 (a)-16. 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 Internal Revenue Code, 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.

(b) *Non-depreciable expenditures for mine development.* Section 23 (cc) provides that certain expenditures (not subject to depreciation allowance under section 23 (l) paid or incurred by the taxpayer for mine development may be deducted or treated as deferred expenses. For the rules governing treatment of such expenditures, see section 23 (cc) and § 39.23 (cc)-1.

§ 39.24 (a)-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 §§ 39.23 (a)-6 to 39.23 (a)-9, inclusive. 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, except in the case of certain transferees as provided in § 39.22 (b) (2)-3 and in the case of a spouse to whom such proceeds are income under section 22 (k). See generally section 22 (b) (1) and (2) and the regulations thereunder.

§ 39.24 (a)-4 *Amounts allocable to exempt income*—(a) *Class of exempt income.* (1) As used in this section, the term "class of exempt income" means any class of income, including interest only to the extent that amounts otherwise allowable under section 23 (a) (2) are allocable thereto (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by chapter 1. Included are any item or class of income, including interest only to the extent that amounts otherwise allowable under section 23 (a) (2) are allocable thereto, constitutionally exempt from the taxes imposed by chapter 1, any item or class, as above defined, excluded from gross income under any provision of section 22 or section 116; and any item or class of income, as above defined, exempt under the provisions of any other law from the taxes imposed by chapter 1. As used in this section, the term "taxable income" means income which is required to be included in gross income; and the term "exempt income" means income which is not required to be included in gross income.

(2) 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 section 24 (a) (5) excludes from the computation of deductions under section 23 all items referable to the production of exempt income, as above defined.

(b) *Determination of amounts allocable to a class of exempt income.* (1) No deduction may be allowed for the amount of any item or part thereof allocable to a class or classes of exempt income. For example, expenses paid or incurred for the production or collection of income which is wholly exempt from income taxes, such as interest or dividends of a type not includible in gross income, are not deductible expenses. 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.

(2) 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.

(c) *Statement of items of exempt income; records.* (1) 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 (i) the amount of each class of exempt income, and (ii) 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) of this section. 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.

(2) The taxpayer shall keep such records as will enable him to make the allocations required by this section (see section 54)

§ 39.24 (a)-5 *Single premium life insurance or endowment contracts.* Amounts paid or accrued on indebtedness incurred or continued, directly or indirectly, to purchase a single premium life insurance or endowment contract are not deductible under section 23 (b) or any other provision of chapter 1. This prohibition applies even though the insurance is not on the life of the taxpayer. A contract shall be considered a single premium life insurance or endowment contract, for the purposes of this section, if substantially all the premiums on such contracts are paid within a period of four years from the date on which the contract was purchased.

§ 39.24 (a)-6 *Taxes and carrying charges chargeable to capital account and treated as capital items*—(a) *General.* In accordance with section 24 (a) (7), items enumerated in paragraph (b) (1) of this section may be capitalized at the election of the taxpayer. Thus, taxes and carrying charges with respect to property, of the type described in this section, are chargeable to capital account at the election of the taxpayer notwithstanding that they are expressly deductible under section 23. No deduction is permitted for any items so treated.

(b) *Taxes and carrying charges.* (1) The following items may upon the election of the taxpayer, in the manner provided in paragraph (c) of this section, be treated as chargeable to capital account (either as a component of original cost or other basis, for the purposes of section 113 (a) or as an adjustment to basis, for the purposes of section 113 (b) (1) (A)) notwithstanding that they are expressly deductible under section 23:

(i) In the case of unimproved and unproductive real property annual taxes, interest on a mortgage, and other carrying charges,

(ii) In the case of real property, whether improved or unimproved and whether productive or unproductive, expenditures (otherwise deductible) paid or incurred in the development thereof or in the construction of an improvement or additional improvement thereon, up to the time the development or construction work has been completed, such as interest on a loan made or continued to furnish funds for this purpose (but not including theoretical interest of a taxpayer using his own funds) taxes of the owner of the property measured by compensation paid to his employees and taxes of such owner imposed on the purchase of materials for such work or on the storage, use, or other consumption in the State of materials for such work which are purchased for storage, use, or other consumption in that State, and other necessary expenditures paid or incurred in connection therewith up to the time the development or construction work has been completed. The development or construction work with respect to which such items are incurred may relate to unimproved and unproductive real estate whether the construction work will make the property productive of taxable income (as in the case of a factory) or not (as in the case of a personal residence) or may relate to property already improved or productive (as in the case of a plant addition or improvement, such as the construction of another floor on a factory or the installation of insulation therein),

(iii) In the case of personal property taxes of an employer measured by compensation for services rendered in transporting machinery or other fixed assets to his plant or in installing them therein, interest on a loan to purchase such property or to pay for transporting or installing the same, and taxes of the owner thereof imposed on the purchase of such property or on the storage, use, or other consumption of such property in the State which is purchased for storage, use, or other consumption in that State, paid or incurred up to the date of installation or the date when such property is first put into use by the taxpayer, whichever date is later,

(iv) Any other taxes and carrying charges with respect to property, otherwise deductible, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to capital account.

(2) If for any taxable year there are two or more items, such as social security taxes, use taxes, or any other type of items above described, relating to the same project to which the election is applicable, the taxpayer may elect to capitalize any one or more of such items even though he does not elect to capitalize the remaining items or to capitalize items of the same type relating to other projects. However, if several items of the same type are incurred with respect to a single project the election to capitalize must, if exercised, be exercised as to all items of that type.

(3) Once, however, such an election is made under subparagraph (1) (ii), (iii) or (iv) of this paragraph to capitalize a given charge incurred with respect to a particular project, charges of the same type incurred with respect to the particular project in subsequent years, whether they be social security taxes, use taxes, sales taxes, or any other item enumerated in any of these subparagraphs, must also be capitalized for the entire period to which the election so to treat items of that type is applicable. The term "project" for this purpose in the case of items included in subparagraph (1) (ii) of this paragraph means the particular development or construction work with respect to which the charge as to which the election was exercised was incurred, and in the case of items included in subparagraph (1) (iii) of this paragraph the term means the act of transporting, installing, or putting into use of the machinery or other fixed assets. An election under subparagraph (1) (i) of this paragraph, however, may be exercised for a given year without regard to the manner in which the same type of item with respect to the same property was treated by the taxpayer for a prior year.

(4) The following examples are illustrative of the application of the provisions of this paragraph:

Example (1). A in 1952 and 1953 pays annual taxes and interest on a mortgage on a piece of property. During 1952, the property is vacant and unproductive, but throughout 1953, A operates the property as a parking lot. A may capitalize the taxes and mortgage interest paid in 1952 but not the taxes and mortgage interest paid in 1953.

Example (2). X began in February 1952 the erection of a building for himself. X in 1952, in connection with the erection of the building, paid $6,000 social security taxes, which in his 1952 return he elected to capitalize. X must continue to capitalize the social security taxes paid in connection with the erection of the building until its completion in 1954.

Example (3). Assume the facts in example (2) except that in November 1952, X also begins to build a hotel which will be completed in 1955. In 1952 X pays $3,000 social security taxes in connection with the erection of the hotel. X's election to capitalize the social security taxes paid in erect-

ing the building started in February 1952 does not bind him to capitalize the social security taxes paid in erecting the hotel; he may deduct the $3,000 social security taxes paid in erecting the hotel.

Example (4). X in 1952 began the erection of a building for himself, which would take three years to complete. X in 1952 paid $4,000 social security taxes and $8,000 interest on a building loan in connection with this building. X may elect to capitalize the social security taxes although he deducts the interest charges.

Example (5). A purchases machinery in 1952 for use in his factory. He pays social security taxes on the labor for transportation and installation, as well as interest on a loan to obtain funds to pay for the machinery and for installation costs. A may capitalize the social security taxes and the interest up to the date of installation or until the machinery is first put into use by him, whichever is later.

(5) The sole effect of section 24 (a) (7) is to permit the items enumerated in subparagraph (1) of this paragraph to be charged to capital account notwithstanding that a deduction is expressly provided therefor in section 23. Any item not charged to capital account which is otherwise deductible under section 23 is still deductible. An item may not be charged to capital account under this section where such treatment would be disallowed whether or not a deduction is expressly provided therefor in section 23 (such, for example, as maintenance expenses and the cost of repairs and upkeep of a personal residence) This section does not prevent an item from being treated as a capital item which would otherwise be allowed to be so treated nor does it have the effect of making deductible an item which is not deductible under section 23 (such, for example, as salaries or other compensation paid or incurred for services rendered in the construction of property)

(6) In the absence of a provision in this section for treating a given item as a capital item, this section has no effect on the treatment otherwise accorded such item. Thus, items which are otherwise deductible are deductible notwithstanding the provisions of this section, and items which are otherwise treated as capital items are to be so treated. Nor is the absence of a provision in this section to be construed as withdrawing or modifying the right now given to the taxpayer under some other provision of chapter 1 of the Code or of the regulations promulgated thereunder to elect to capitalize or to deduct a given item. See § 39.23 (m)-16, making intangible drilling and development costs chargeable to capital or to expenses at the taxpayer's option and § 39.23 (c)-2, making certain Federal duties and excise taxes deductible unless the taxpayer has added them to the expenses of the business or the cost of the articles of merchandise.

(c) *Manner of exercising election.* If the taxpayer elects to capitalize an item or items under this section, such election shall be exercised by filing with the original return a statement for that year indicating the item or items (whether with respect to the same project or to different projects) which the taxpayer elects to treat as chargeable to capital account (either as a component of original cost or other basis, for the purposes of section 113 (a) or as an adjustment to basis, for the purposes of section 113 (b) (1) (A))

(d) *Allocation.* If any tax or carrying charge with respect to property is in part a type of item described in paragraph (b) of this section and in part a type of item or items with respect to which no election to treat as a capital item is given, a reasonable proportion of such tax or carrying charge, determined in the light of all the facts and circumstances in each case, shall be allocated to each item. Apportionment must in all cases be reasonable.

Example. A, the owner of a factory on which a new addition is under construction, in 1952 pays its general manager, B, a salary of $4,000 and social security taxes of $120. B spends nine-tenths of his time in the general business of the firm and the remaining tenth in supervising the construction work. A treats as expenses $3,600 of B's salary and charges the remaining $400 to capital account. A may also capitalize $12 of the $120 social security taxes.

§ 39.24 (b) *Statutory provisions; items not deductible; losses from sales or exchanges of property.*

SEC. 24. *Items not deductible.* * * *

(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 to 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.

§ 39.24 (b)-1 *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) 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, 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, 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 501, 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 section, 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, 1952, the M Corporation owned all of the stock of the O Corporation which for the calendar year 1951 was a personal holding company under section 501. 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, 1952, 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, 1952, 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, 1952, 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).

§ 39.24 (c) *Statutory provisions; items not deductible; unpaid expenses and interest.*

SEC. 24 *Items not deductible.* * * *

(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).

§ 39.24 (c)-1 *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 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 1952 or within two and one-half months after the close thereof, but claims a deduction for the year 1952 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 1952. 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 1952. The provisions of 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, 1953, no deduction therefor would be allowable in computing its net income for the year in which the payment was made.

§ 39.24 (d) *Statutory provisions; items not deductible; holders of life or terminable interest.*

SEC. 24. *Items not deductible.* * * *

(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 chapter (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.

§ 39.24 (d)-1 *Life or terminable interests.* (a) 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)

(b) 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 chapter 1 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.

§ 39.24 (e)-(f) *Statutory provisions; items not deductible; cross reference; expenses attributable to unharvested crops sold with land.*

SEC. 24. *Items not deductible.* * * *

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

(f) *Sale of land with unharvested crop.* Where an unharvested crop sold by the taxpayer is considered under the provisions of section 117 (j) (3) as "property used in the trade or business" in computing net income no deduction (whether or not for the taxable year of the sale and whether for expenses, depreciation, or otherwise) attributable to the production of such crop shall be allowed.

[Sec. 24 (f) as added by sec. 323 (b), Rev. Act 1951]

§ 39.24 (f)-1 *Items attributable to an unharvested crop sold with the land.* In computing net income no deduction shall be allowed in respect of items attributable to the production of an unharvested crop which is sold, exchanged, or involuntarily converted with the land and which is considered as property used in the trade or business under section 117 (j) (3) Such items shall be so treated whether or not the taxable year involved is that of the sale, exchange, or conversion of such crop and whether they are for expenses, depreciation, or otherwise. If the taxable year involved is not that of the sale, exchange, or conversion of such crop, a recomputation of the tax liability for such year shall be made; such recomputation should be in the form of an "amended return" if necessary. For the adjustments to basis as a result of such disallowance, see § 39.113 (b) (1)-1.

CREDITS AGAINST NET INCOME

§ 39.25 *Statutory provisions; credits of individual against net 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, if such interest is included in gross income under section 22, and if, under the Act authorizing the issue of such obligations, as amended and supplemented, such interest is exempt from normal tax.

(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. (For reduction of credit under paragraph (1) or (2) on account of amortizable bond premium, see section 125.)

(3) *Normal-tax exemption.* [Repealed by sec. 102 (b) (2), Rev. Act 1945.]

(4) Earned-income definitions. [Repealed by sec. 107 (a), Rev. Act 1943]

(b) *Credits for both normal tax and surtax*—(1) *Credits.* There shall be allowed for the purposes of both the normal tax and the surtax, the following credits against net income:

(A) An exemption of $600 for the taxpayer; and an additional exemption of $600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer;

(B) (i) An additional exemption of $600 for the taxpayer if he has attained the age of 65 before the close of his taxable year; and

(ii) An additional exemption of $600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse has attained the age of 65 before the close of such taxable year, and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer;

(C) (i) An additional exemption of $600 for the taxpayer if he is blind at the close of his taxable year; and

(ii) An additional exemption of $600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. For the purposes of this clause the determination of whether the spouse is blind shall be made as of the close of the taxable year of the taxpayer, unless the spouse dies during such taxable year, in which case such determination shall be made as of the time of such death;

(iii) For the purposes of this subparagraph an individual is blind only if either: His central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or his visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees;

(D) An exemption of $600 for each dependent whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than $600, except that the exemption shall not be allowed in respect of a dependent who has made a joint return with his spouse under section 51 for the taxable year beginning in such calendar year.

(2) *Determination of status.* For the purposes of this subsection—

(A) The determination of whether an individual is married shall be made as of the close of his taxable year, unless his spouse dies during his taxable year, in which case such determination shall be made as of the time of such death; and

(B) An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

(3) *Definition of dependent.* As used in this chapter the term "dependent" means any of the following persons over half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer:

(A) A son or daughter of the taxpayer, or a descendant of either,

(B) A stepson or stepdaughter of the taxpayer,

(C) A brother, sister, stepbrother, or stepsister of the taxpayer,

(D) The father or mother of the taxpayer, or an ancestor of either,

(E) A stepfather or stepmother of the taxpayer,

(F) A son or daughter of a brother or sister of the taxpayer,

(G) A brother or sister of the father or mother of the taxpayer,

(H) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer.

As used in this paragraph, the terms "brother" and "sister" include a brother or sister by the half-blood. For the purposes of determining whether any of the foregoing relationships exist, a legally adopted child of a person shall be considered a child of such person by blood. The term "dependent" does not include any individual who is a citizen or subject of a foreign country unless such individual is a resident of the United States or of a country contiguous to the United States. A payment to a wife which is includible under section 22 (k) or section 171 in the gross income of such wife shall not be considered a payment by her husband for the support of any dependent.

[Sec. 25 as amended by sec. 6 (a), Rev. Act 1940; secs. 111 (a), 113, Rev. Act 1941; secs. 112 (b), 120 (e) (1), 126 (l) (1), 131 (a) (1), (b), Rev. Act 1942; sec. 107, Rev. Act 1943; sec. 10 (a), (b), Individual Income Tax Act 1944; sec. 102 (a), (b) (2), Rev. Act 1945; sec. 201, Rev. Act 1948; sec. 310 (a), Rev. Act 1951]

§ 39.25-1 *Credits of individuals for purpose of normal tax.* The taxpayer's net income as determined pursuant to sections 21 to 24, inclusive, is reduced, for the purpose of computing the normal tax by (a) the income exempt from normal tax only received upon certain obligations of the United States and upon certain obligations of corporations organized under Act of Congress which are instrumentalities of the United States, and (b) the credits for both normal tax and surtax under section 25 (b).

§ 39.25-2 *Credits of individuals for purpose of normal tax and surtax*—(a) *In general.* For the purposes of the normal tax and the surtax on individuals, there are allowed as credits against net income the exemptions specified in section 25 (b) Such credits include (1) the exemptions for an individual taxpayer and spouse (the so-called personal exemptions) (2) the additional exemptions for a taxpayer attaining the age of 65 years and spouse attaining the age of 65 years (the so-called old-age exemptions) (3) the additional exemptions for a blind taxpayer and a blind spouse, and (4) the exemptions for dependents of the taxpayer.

(b) *Exemptions for individual taxpayer and spouse (so-called personal exemptions)* There are allowed by section 25 (b) (1) (A) an exemption of $600 for the taxpayer and an additional exemption of $600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. Since, in the case of a joint return, there are two taxpayers (although under section 51 (b) there is only one income for the two taxpayers on such return—i. e. their aggregate income) two exemptions of $600 are allowed on such return, one for each taxpayer spouse. If in any case a joint return is made by the taxpayer and his spouse, no exemption is allowed any other person for such spouse even though such other person would have been entitled to claim an exemption for such spouse as a dependent if such joint return had not been made.

(c) *Exemptions for taxpayer attaining the age of 65 and spouse attaining the age of 65 (so-called old-age exemptions).* (1) Section 25 (b) (1) (B) provides an additional exemption of $600 for the taxpayer if he has attained the age of 65 before the close of his taxable year. An additional exemption of $600 is also allowed to the taxpayer for his spouse if a separate return is made by the taxpayer and if the spouse has attained the age of 65 before the close of the taxable year of the taxpayer and, for the calendar year in which the taxable year of the taxpayer begins, the spouse has no gross income and is not the dependent of another taxpayer. If a husband and wife make a joint return, an old-age exemption of $600 will be allowed as to each taxpayer spouse who has attained the age of 65 before the close of the taxable year for which the joint return is made. The exemptions under section 25 (b) (1) (B) are in addition to the exemptions for the taxpayer and spouse under section 25 (b) (1) (A)

(2) In determining the age of an individual for the purposes of the exemption for old age, the last day of the taxable year of the taxpayer is the controlling date. Thus, in the event of a separate return by a husband, no additional exemption for old age may be claimed for his spouse unless such spouse has attained the age of 65 on or before the close of the taxable year of the husband. In no event shall the additional exemption for old age be allowed on a separate return of the taxpayer with respect to a spouse who dies before attaining the age of 65 even though such spouse would have attained the age of 65 before the close of the taxable year of the taxpayer. For the purposes of the old-age exemption, an individual attains the age of 65 on the first moment of the day preceding his sixty-fifth birthday. Accordingly, an individual whose sixty-fifth birthday falls on January 1 in a given year attains the age of 65 on the last day of the calendar year immediately preceding.

(d) *Exemptions for the blind.* (1) Section 25 (b) (1) (C) provides an additional exemption of $600 for the taxpayer if he is blind at the close of his taxable year. An additional exemption is also allowed to the taxpayer for his spouse if the spouse is blind and, for the calendar year in which the taxable year of the

taxpayer begins, has no gross income and is not the dependent of another taxpayer. The determination of whether the spouse is blind shall be made as of the close of the taxable year of the taxpayer, unless the spouse dies during such taxable year, in which case such determination shall be made as of the time of such death.

(2) The exemptions for the blind are in addition to the exemptions for the taxpayer and spouse under section 25 (b) (1) (A) and are also in addition to the exemptions under section 25 (b) (1) (B) for taxpayers and spouses attaining the age of 65 years. Thus, a single individual who has, before the close of his taxable year, attained the age of 65 years and who is blind at the close of his taxable year is entitled, in addition to the so-called personal exemption of $600, to two further exemptions, each of $600, one by reason of his age and the other by reason of his blindness. If a husband and wife make a joint return, an exemption of $600 for the blind will be allowed as to each taxpayer spouse who is blind at the close of the taxable year for which the joint return is made.

(3) A taxpayer claiming an exemption allowed by section 25 (b) (1) (C) for a blind taxpayer or a blind spouse shall, if the individual for whom the exemption is claimed is not totally blind as of the last day of the taxable year of the taxpayer (or in the case of a spouse who dies during such taxable year as of the time of such death) attach to his return a certificate from a physician skilled in the diseases of the eye or a registered optometrist stating that as of the applicable status determination date in the opinion of such physician or optometrist (i) the central visual acuity of the individual for whom the exemption is claimed did not exceed 20/200 in the better eye with correcting lenses or (ii) such individual's visual acuity was accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees. If such individual is totally blind as of the status determination date there shall be attached to the return a statement by the person or persons making the return setting forth such fact.

(e) *Exemptions for dependents.* Section 25 (b) (1) (D) allows to a taxpayer an exemption of $600 for each dependent whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than $600, who receives more than one-half of his support from the taxpayer for such calendar year and who does not file a joint return with his spouse. For the purposes of this credit a dependent is a person who is related to the taxpayer within one of the following relationships: child, the descendants of such child; stepchild; brother; sister; brother or sister by the half blood; stepbrother or stepsister· parent; the ancestors of such parent; stepfather or stepmother· son or daughter of the taxpayer's brother or sister; brother or sister of the taxpayer's father or mother; son-in-law· daughter-in-law· father-in-law· mother-in-law; brother-in-law· or sister-in-law. In the case of a joint return it is not necessary that the prescribed relationship exist between the person claimed as a dependent and the spouse who furnishes the support; it is sufficient if the prescribed relationship exists with respect to either spouse. Thus, a husband and wife making a joint return may claim as a dependent a daughter of the wife's brother (wife's niece) even though the husband is the one who furnishes the chief support. The relationship of affinity once existing will not terminate by divorce or the death of a spouse. A legally adopted child of a person shall be considered a child of such person by blood. A citizen or subject of a foreign country may not be claimed as a dependent, unless he is a resident of the United States, Canada, or Mexico at some time during the calendar year in which the taxable year of the taxpayer begins. Whether or not over half of a person's support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer shall be determined by reference to the amount of expense incurred by the taxpayer for such support. A payment to a wife which is includible under section 22 (k) or section 171 in the gross income of such wife shall not be considered a payment by her husband for the support of any dependent.

(2) The only exemption allowed for a dependent of the taxpayer is that provided by section 25 (b) (1) (D) The exemptions provided by section 25 (b) (1) (B) (old-age exemptions) and section 25 (b) (1) (C) (exemptions for the blind) are allowed only for the taxpayer or his spouse. Thus, if a taxpayer provides the entire support of his father, who meets all the requirements of a dependent under section 25 (b) (3) and who is over the age of 65 years, the taxpayer is entitled only to the one exemption under section 25 (b) (1) (D) of $600 for his father as a dependent, and is not entitled to any additional exemption because of his father's age.

(f) *Determination of husband and wife status.* For the purpose of determining the right of an individual to claim an exemption for his spouse under section 25 (b) the determination of whether such individual is married shall be made as of the close of his taxable year, unless his spouse dies during such year, in which case such determination shall be made as of the time of such death. An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

(g) *Alien resident of Puerto Rico.* A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year and subject to tax under sections 11 and 12 is allowed as credits against net income the exemptions specified in section 25 (b) even though as to the United States such individual is a nonresident alien. See, however, section 51 (b) (2) and regulations thereunder which provide that a joint return may not be made if either the husband or wife at any time during the taxable year is a nonresident alien.

§ 39.26 (a) *Statutory provisions; credits of corporations; interest on obligations of the United States and its instrumentalities.*

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). (For reduction of credit under this subsection on account of amortizable bond premium, see section 125.)

[Sec. 26 (a) as amended by sec. 126 (1) (2), Rev. Act 1942]

§ 39.26 (a)-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.

§ 39.26 (b) *Statutory provisions; credits of corporations; dividends received.*

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— * * *

(b) *Dividends received.* An amount equal to the sum of—

(1) *In general.* 85 per centum of the amount received as dividends (other than dividends described in paragraph (2) on the preferred stock of a public utility) from a domestic corporation which is subject to taxation under this chapter.

(2) *Certain preferred stock*—(A) *Calendar year 1951.* * * * [Not applicable.]

(B) *Taxable years beginning after March 31, 1951, and before April 1, 1954.* In the case of taxable years beginning after March 31, 1951, and before April 1, 1954, 62 per centum of the amount received as dividends on the preferred stock of a public utility which is subject to taxation under this chapter and with respect to which the credit provided in section 26 (h) for dividends paid is allowable.

(C) *Taxable years beginning after March 31, 1954.* In the case of taxable years beginning after March 31, 1954, 59 per centum of the amount received as dividends on the preferred stock of a public utility which is subject to taxation under this chapter and with respect to which the credit provided in section 26 (h) for dividends paid is allowable.

(3) *Dividends received from certain foreign corporations.* In the case of dividends received from a foreign corporation (other than a foreign personal holding company) which is subject to taxation under this chapter, if, for an uninterrupted period of not less than 36 months ending with the close of such foreign corporation's taxable year in which such dividends are paid (or, if the corporation has not been in existence for 36 months at the close of such taxable year, for the period the foreign corporation has been in existence as of the close of such tax-

able year) such foreign corporation has been engaged in trade or business within the United States and has derived 50 per centum or more of its gross income from sources within the United States—

(A) An amount equal to 85 per centum of the dividends received out of its earnings or profits specified in clause (2) of the first sentence of section 115 (a), but such amount shall not exceed an amount which bears the same ratio to 85 per centum of such dividends received out of such earnings or profits as the gross income of such foreign corporation for the taxable year from sources within the United States bears to its gross income from all sources for such taxable year, and

(B) An amount equal to 85 per centum of the dividends received out of that part of its earnings or profits specified in clause (1) of the first sentence of section 115 (a) accumulated after the beginning of such uninterrupted period, but such amount shall not exceed an amount which bears the same ratio to 85 per centum of such dividends received out of such accumulated earnings or profits as the gross income of such foreign corporation from sources within the United States for the portion of such uninterrupted period ending at the beginning of such taxable year bears to its gross income from all sources for such portion of such uninterrupted period.

For determination of earnings or profits distributed in any taxable year, see section 115 (b).

For the purpose of this subsection (but not for the purposes of computing adjusted net income), if the whole or any part of a dividend is received after August 31, 1950, in property other than money, then, with respect to such property, the shareholder shall not be considered to have received as a dividend an amount in excess of the adjusted basis of such property in the hands of the distributing corporation at the time of distribution increased in the amount of gain or decreased in the amount of loss recognized to the distributing corporation by reason of such distribution. The credit allowed under this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, 42 Stat. 849 (U. S. C., title 15, c. 4), 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. In no event shall the credit allowed by this subsection exceed 85 per centum of the adjusted net income computed without regard to the deduction allowed by section 23 (s).

[Sec. 26 (b) as amended by sec. 105 (e) (1), Rev. Act 1942; sec. 122 (g) (4), Rev. Act 1945; sec. 122 (a), Rev. Act 1950; secs. 122 (a), 311 (a), Rev. Act 1951]

§ 39.26 (b)-1 *Credit for dividends received*—(a) *Dividends on stock of domestic corporations.* A credit is provided in section 26 (b) for dividends received from a domestic corporation which is subject to taxation under chapter 1 of the Internal Revenue Code. Such credit of a corporation for a taxable year is, except as provided in paragraph (d) of this section, an amount equal to 85 percent of such dividends received by the corporation during the taxable year. The credit shall be determined without regard to dividends received on the preferred stock of a public utility with respect to which the credit for dividends paid provided in section 26 (h) is allowable to the distributing corporation. For credit for such dividends received on the preferred stock of a public utility, see paragraph (b) of this section. If a credit for dividends paid is not allowable to the distributing corporation under section 26 (h) with respect to the dividends on its preferred stock, such dividends received from a domestic public utility corporation subject to taxation under chapter 1 are includible in determining the credit under this paragraph.

(b) *Dividends on certain preferred stock of public utilities.* A credit is provided in section 26 (b) (2) for dividends received on certain preferred stock of certain public utility corporations subject to taxation under chapter 1 of the Internal Revenue Code. Such credit is allowable only for dividends received on the preferred stock of a public utility with respect to which the credit for dividends paid provided in section 26 (h) is allowable to the distributing corporation. The credit of a corporation under section 26 (b) (2) for a taxable year is, except as provided in paragraph (d) of this section, an amount equal to the following percent of such dividends received by the corporation during the taxable year:

	Percent
For taxable years beginning before Apr. 1, 1954	62
For taxable years beginning after Mar. 31, 1954	59

For taxable years beginning before April 1, 1954, and ending after March 31, 1954, see § 39.108-2.

(c) *Dividends on stock of certain foreign corporations.* (1) A credit is provided in section 26 (b) (3) for dividends received from a foreign corporation (other than a foreign personal holding company as defined in section 331) which is subject to taxation under chapter 1 of the Internal Revenue Code if, for an uninterrupted period of not less than 36 months ending with the close of the foreign corporation's taxable year in which the dividends are paid, such foreign corporation has been engaged in trade or business within the United States and has derived 50 percent or more of its gross income from sources within the United States. If the foreign corporation has been in existence less than 36 months as of the close of the taxable year in which the dividends are paid, then the applicable uninterrupted period to be taken into consideration in lieu of the uninterrupted period of 36 or more months is the entire period such corporation has been in existence as of the close of such taxable year. An uninterrupted period which satisfies the twofold requirement with respect to business activity and gross income may start at a date later than the date on which the foreign corporation first commenced an uninterrupted period of engaging in trade or business within the United States, but the applicable uninterrupted period is in any event the longest uninterrupted period which satisfies such twofold requirement.

(2) The credit of a corporation under section 26 (b) (3) for a taxable year is, except as provided in paragraph (d) of this section, an amount equal to 85 percent of such dividends—

(i) Received out of the foreign corporation's earnings or profits for its taxable year in which the dividends are paid (computed as of the close of such taxable year without diminution by reason of any distributions made during such taxable year) without regard to the amount of the earnings and profits at the time the distribution was made, but not in excess of an amount which bears the same ratio to 85 percent of such dividends received as the gross income of the foreign corporation for such taxable year from sources within the United States bears to its gross income from all sources for such year, and

(ii) Received out of that part of the foreign corporation's earnings or profits accumulated after February 28, 1913, which has accumulated after the beginning of the applicable uninterrupted period, but not in excess of an amount which bears the same ratio to 85 percent of such dividends received as the gross income of the foreign corporation from sources within the United States for that portion of the applicable uninterrupted period which ends at the beginning of its taxable year in which the dividends are paid bears to its gross income from all sources for the same portion of such applicable uninterrupted period.

(3) The determination of earnings or profits distributed in any taxable year shall be made in accordance with the principles of section 115 (b) of the Internal Revenue Code. For the determination of the source of income, see section 119 and the regulations thereunder.

(4) The application of section 26 (b) (3) may be illustrated by the following examples:

Example (1). Corporation A (a foreign corporation filing its income tax return on a calendar year basis) whose stock is 100 percent owned by Corporation B (a domestic corporation filing its income tax return on a calendar year basis) for the first time engaged in trade or business within the United States on January 1, 1941, and qualifies under section 26 (b) (3) for the entire period beginning on that date and ending on December 31, 1952. Corporation A had accumulated earnings or profits of $50,000 immediately prior to January 1, 1941, and had earnings or profits of $10,000 for each taxable year during the uninterrupted period from January 1, 1941, through December 31, 1952. It derived for the period from January 1, 1941, through December 31, 1951, 90 percent of its gross income from sources within the United States, and in 1952 derived 95 percent of its gross income from sources within the United States. During the calendar years 1941, 1942, 1943, 1944, and 1945 Corporation A distributed in each year $15,000; during the calendar years 1946, 1947, 1948, 1949, 1950, and 1951 it distributed in each year $5,000; and during the year 1952, $50,000. For 1952 a dividends received credit of $31,025 is allowable to Corporation B with respect to the $50,000 received from Corporation A, computed as follows:

(i) $8,075 which is $8,500 (85 percent of the $10,000 of earnings or profits of the taxable year) multiplied by 95 percent (the portion of the gross income of Corporation A derived during the taxable year from sources within the United States), plus

(ii) $22,950 which is $25,500 (85 percent of $30,000, that part of the earnings or profits accumulated after the beginning of the uninterrupted period) multiplied by 90 percent (the portion of the gross income of Corporation A derived from sources within the United States during that portion of the uninterrupted period ending at the beginning of the taxable year).

Example (2). If in example (1) Corporation A for the taxable year 1952 had incurred a deficit of $10,000 (shown to have been incurred before December 31), and if it had distributed $50,000 on December 31, 1952, the dividends received credit allowable to Corporation B would be $15,300, computed by multiplying $17,000 (85 percent of $20,000 earnings or profits accumulated after the beginning of the uninterrupted period) by 90 percent (the portion of the gross income of Corporation A derived from United States sources during that portion of the uninterrupted period ending at the beginning of the taxable year).

(d) *Limitations on credit.* No credit is allowable under section 26 (b) in respect of dividends received from a corporation organized under the China Trade Act, 1922 (15 U. S. C. (1946) c. 4) 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. The credit under section 26 (b) (that is, the sum of the credits determined under paragraphs (a) (b) and (c) of this section) is limited to 85 percent of the corporation's adjusted net income computed without regard to the deduction for net operating loss allowed by section 23 (s) For the purpose of section 26 (b) and this section (but not for the purpose of computing adjusted net income) if the whole or any part of a dividend is received in property other than money, the amount of such dividend in such property shall not be considered to be in excess of the adjusted basis of such property in the hands of the distributing corporation at the time of distribution increased in the amount of gain or decreased in the amount of loss recognized to the distributing corporation by reason of such distribution. In no event shall the amount of the dividend in property other than money be treated as an amount greater than the fair market value of such property received by the shareholder. For definition of the term "adjusted net income" see section 13 (a) (1) and § 39.13-1.

§ 39.26 (c) *Statutory provisions; credits of corporations; net operating loss of preceding year*

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—* * *

(c) *Net operating loss of preceding year*—(1) *Amount of credit.* The amount of net operating loss (as defined in paragraph (2)) of the corporation for the preceding taxable year * * * but not in excess of (A) the section 102 net income for the taxable year, in the case of the tax imposed by section 102; (B) the Supplement P net income for the taxable year, in the case of the computations required under Supplement P· or (C) the Subchapter A net income for the taxable year, in the case of the tax imposed under Subchapter A.

(2) *Definition.* As used in this section the term "net operating loss" means the excess of the deductions allowed by this chapter 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 chapter, 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.

(C) For the purposes of this paragraph, the net operating loss deduction provided in section 122 shall not be allowed.

* * * * *

[Sec. 26 (c) as amended by sec. 211 (j), Rev. Act 1939; sec. 132 (a), Rev. Act 1942]

§ 39.26 (c)-1. *Credit of corporation for net operating loss of preceding year* (a) Since the net operating loss credit allowed by section 26 (c) cannot exceed the section 102 net income for the taxable year in the case of the tax imposed by section 102, the Supplement P net income for the taxable year in the case of the computations required under Supplement P or the subchapter A net income for the taxable year in the case of the tax imposed under subchapter A of chapter 2, it is the smaller of the following amounts:

(1) The excess of the deductions allowed by chapter 1 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)

(2) (i) The section 102 net income for the taxable year, in the case of the tax imposed by section 102; (ii) the Supplement P net income for the taxable year, in the case of the computations required under Supplement P· (iii) the subchapter A net income for the taxable year, in the case of the tax imposed under subchapter A of chapter 2.

(b) 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 § 39.23 (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.

(c) In computing deductions for the preceding taxable year the net operating loss provided in section 122 shall not be allowed.

(d) 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 chapter 1 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.

(e) The provisions of this section may be illustrated by the following example:

Example. For 1953 the X Corporation, which makes its income tax returns on the calendar year basis, has a net income of $750,000, computed on the accrual basis and without the net operating loss deduction provided in section 23 (s), capital losses of $550,000, and no capital gains. Its Federal normal tax and surtax for 1953, not allowable as a deduction under section 23, are $20,500, and it made no contributions during that year. For 1952 its gross income was $500,000, and its allowable deductions were $1,500,000. Included in such deductions was $500,000 for net operating loss (attributable to 1951), allowed as a deduction under section 23 (s) and computed under section 122. There was likewise included in such deductions $300,000 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 $100,000. For 1952 the corporation had $300,000 of wholly tax-exempt interest, and paid $200,000 in interest on indebtedness incurred to carry obligations from which such tax-exempt interest was derived. The net operating loss credit available to such corporation for 1953 is computed as follows:

Deductions for 1952		$1,500,000
Less: Excess of depletion deduction computed on basis of discovery value over amount allowable for depletion without reference to discovery value or percentage depletion ($300,000 minus $100,000)	$200,000	
Net operating loss deduction	500,000	700,000
Deductions as limited by sections 26 (c) (2) (A) and 26 (c) (2) (C)		800,000
Gross income for 1952	$500,000	
Plus tax-exempt interest minus interest paid ($300,000 minus $200,000)	100,000	
Gross income contemplated by section 26 (c) (2) (B)		600,000
Excess of deductions over gross income for 1952		200,000
Net income for 1953 (computed without net operating loss deduction provided in section 23 (s))		750,000
Less: Capital losses not allowed by section 117 (d)	$550,000	
Federal normal tax and surtax for 1953 not allowed as a deduction under section 23	20,500	570,500
Section 102 net income for 1953		179,500

The credit for the net operating loss for the preceding year available to the X Corporation for 1953 is $179,500. Inasmuch as the excess of deductions over gross income for 1952, as computed above, is greater than the section 102 net income for 1953, the net operating loss credit available to the X Corporation for 1953 is equal to the section 102 net income for 1953. If the excess of deductions over gross income for 1952, as computed above, were smaller than the section 102 net income for 1953, the entire amount of such excess would be allowed as the net operating loss for 1953.

(f) Similar rules for the computation of the net operating loss credit are applicable in the case of computations required under Supplement P or the tax imposed under subchapter A of chapter 2.

§ 39.26 (d) *Statutory provisions; credits of corporations; earnings or profits of bank affiliates.*

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—* * *

(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.

§ 39.26 (d)-1 *Bank affiliates.* (a) 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 (12 U. S. C. 221a) 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 (12 U. S. C. 61) 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 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) exceed the amount required to be devoted under such section 5144 to the acquisition of readily marketable assets other than bank stock.

(b) 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 section 5144 (b) and (c) of the Revised Statutes.

§ 39.26 (e)-(h) *Statutory provisions; credits of corporations; cross references; dividends paid on certain preferred stock.*

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—* * *

(e) *Income subject to excess profits tax.* [Repealed by sec. 122 (g) (1), Rev. Act 1945.]

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

[Sec. 26 (f) as amended by sec. 105 (d), Rev. Act 1942]

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

[Sec. 26 (g) as amended by sec. 105 (d), Rev. Act 1942]

(h) *Credit for Dividends Paid on Certain Preferred Stock*—(1) *Amount of credit.* In the case of a public utility, (A) * * * [Applicable only to calendar year 1951], (B) for a taxable year beginning after March 31, 1951, and before April 1, 1954, an amount equal to 27 per centum of the lesser of (i) the amount of dividends paid during the taxable year on its preferred stock or (ii) the adjusted net income for such taxable year minus the credit for dividends received provided in subsection (b) for such year, and (C) for a taxable year beginning after March 31, 1954, an amount equal to 30 per centum of the lower of (i) the amount of dividends paid during the taxable year on its preferred stock or (ii) the adjusted net income for such taxable year minus the credit for dividends received provided in subsection (b) for such year. For the purposes of the credit provided in this subsection the amount of dividends paid shall not include any amount distributed in the current taxable year with respect to dividends unpaid and accumulated in any taxable year ending prior to October 1, 1942. Amounts distributed in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year shall for the purposes of this paragraph be deemed to be distributed with respect to the earliest year or years for which there are dividends unpaid and accumulated. The credit provided in this subsection shall be subtracted from the basic surtax credit provided in section 27.

(2) *Definitions.* As used in this subsection, subsection (b), and sections 13 and 15—

(A) *Public utility.* The term "public utility" means a corporation engaged in the furnishing of telephone service or in the sale of electric energy, gas, or water, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof or by an agency or instrumentality of the United States or by a public utility or public service commission or other similar body of the District of Columbia or of any State or political subdivision thereof.

(B) *Preferred stock.* The term "preferred stock" means stock issued prior to October 1, 1942, which during the whole of the taxable year (or the part of the taxable year after its issue) was stock the dividends in respect of which were cumulative, limited to the same amount, and payable in preference to the payment of dividends on other stock. Stock issued on or after October 1, 1942, shall be deemed for the purposes of this paragraph to have been issued prior to October 1, 1942, if it was issued (including issuance either by the same or another corporation in a transaction which is a reorganization, as defined in section 112 (g) (1), or a transaction to which section 112 (b) (10), or so much of section 112 (d) or (e) as relates to section 112 (b) (10), is applicable, or which is a transaction subject to Supplement R) to refund or replace bonds or debentures issued prior to October 1, 1942, or to refund or replace other preferred stock (including stock which is preferred stock by reason of this sentence), but only to the extent that the par or stated value of the new stock does not exceed the par, stated, or face value of the bonds or debentures issued prior to October 1, 1942, or the other preferred stock, which such new stock is issued to refund or replace. The determination of whether stock was issued to refund or replace bonds or debentures issued prior to October 1, 1942, or to refund or replace other preferred stock, shall be made under regulations prescribed by the Commissioner with the approval of the Secretary.

[Sec. 26 (h) as added by sec. 133, Rev. Act 1942; amended by sec. 116, Rev. Act 1943; secs. 121 (g) (1), 122 (b), Rev. Act 1950; sec. 202 (a), Excess Profits Tax Act 1950; sec. 122 (b), Rev. Act. 1951]

§ 39.26 (h)-1 *Credit for dividends paid on preferred stock of public utilities*—(a) *Amount of credit.* (1) A credit is provided in section 26 (h) for dividends paid during the taxable year by certain public utility corporations (see paragraph (b) of this section) on certain preferred stock (see paragraph (c) of this section) This credit is an amount equal to a specified percent of the lesser of (1) the amount of the dividends paid during the taxable year by a public utility on its preferred stock or (2) the adjusted net income of the public utility for such taxable year minus the credit for dividends received allowable to such public utility for such taxable year under section 26 (b). The specified percent applicable for the respective taxable years is as follows:

	Percent
For taxable years beginning before April 1, 1954	27
For taxable years beginning after March 31, 1954	30

For taxable years beginning before April 1, 1954, and ending after March 31, 1954,

see § 39.108-2. However, the amount of dividends paid in a given taxable year shall not include any amount distributed in such year with respect to dividends unpaid and accumulated in any taxable year ending before October 1, 1942. If any distribution is made in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year, such distribution will be deemed to have been made with respect to the earliest year or years for which there are dividends unpaid and accumulated. Thus, if a public utility makes a distribution with respect to a prior taxable year, it shall be considered that such distribution was made with respect to the earliest year or years for which there are dividends unpaid and accumulated, whether or not the public utility states that the distribution was made with respect to such year or years and even though the public utility states that the distribution was made with respect to a later year. Even though it has dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may however, receive credit for dividends paid with respect to the current taxable year. If there are no dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may receive credit for dividends paid with respect to a prior taxable year which ended after October 1, 1942; and such credit may be in addition to a credit for dividends paid with respect to the current taxable year. However, if local law or its own charter requires a public utility to pay all unpaid and accumulated dividends before any dividends can be paid with respect to the current taxable year, such public utility will not receive credit for any distribution in the current taxable year to the extent that there are dividends unpaid and accumulated with respect to taxable years ending before October 1, 1942.

(2) The amount allowable as a credit under section 26 (h) shall be subtracted from the basic surtax credit otherwise computed under section 27 (b)

(b) *Public Utility*. As used in section 26 (h) and this section, public utility means a corporation engaged in the furnishing of telephone service, or in the sale of electric energy gas, or water if the rates charged by such corporation for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof or by an agency or instrumentality of the United States or by a public utility or public service commission or other similar body of the District of Columbia or of any State or political subdivision thereof. If a schedule of rates has been filed with any of the above bodies having the power to disapprove such rates, then such rates shall be considered as established or approved rates even though such body has taken no action on the filed schedule. Rates fixed by contract between the corporation and the purchaser, except where the purchaser is the United States, a State, the District of Columbia, or an agency or political subdivision of the United States, a State, or the District of Columbia, shall not be considered as established or approved rates in those cases where they are not subject to direct control, or where no maximum rate for such contract rates has been established by the United States, a State, the District of Columbia, or by an agency or political subdivision thereof. The credit provided in section 26 (h) will not be denied solely because part of the gross income of the corporation consists of revenue derived from such furnishing or sale at rates which are not so regulated, provided the corporation establishes to the satisfaction of the Commissioner (1) that the revenue from regulated rates and the revenue from unregulated rates are derived from the operation of a single interconnected and coordinated system within a single area or region in one or more States and (2) that the regulation to which it is subject in part of its operating territory is effective to control rates within the unregulated territory so that the rates within the unregulated territory have been and are substantially as favorable to users and consumers as are the rates within the regulated territory.

(c) *Preferred stock*. (1) For the purposes of section 26 (h) and this section, preferred stock means stock which was issued prior to October 1, 1942, and which during the whole of the taxable year (or the part of the taxable year after the actual date of its issue) was stock nonparticipating as to earnings or profits either currently or in liquidation, the dividends in respect of which were cumulative and payable in preference to the payment of dividends on other stock. In addition, the preferred stock must be such that the rate of return is fixed and cannot be changed by a vote of the board of directors or by some similar method. However, if there are several classes of preferred stock, all of which meet the above requirements, the credit provided in section 26 (h) shall not be denied in the case of a given class of preferred stock merely because there is another class of preferred stock whose dividends are to be paid before those of the given class of stock. Likewise, it is immaterial for the purposes of this section whether the stock be voting or nonvoting stock.

(2) Stock issued on or after October 1, 1942, under certain circumstances will be considered as having been issued before October 1, 1942, for purposes of the credit provided in section 26 (h) If the new stock is issued on or after October 1, 1942, to refund or replace bonds or debentures which were issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 26 (h) (2) (B) such new stock shall be considered as having been issued before October 1, 1942. If stock is issued to refund or replace stock which was preferred stock within the meaning of section 26 (h) (2) (B) it shall be immaterial whether the preferred stock so refunded or replaced was issued before, on, or after October 1, 1942. If stock issued on or after October 1, 1942, to refund or replace stock which was issued before October 1, 1942, and which was preferred stock within the meaning of section 26 (h) (2) (B), is not itself preferred stock within the meaning of section 26 (h) (2) (B) no stock issued to refund or replace such stock can be considered preferred stock for purposes of the credit provided in section 26 (h)

(3) In the case of any stock issued on or after October 1, 1942, to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 26 (h) (2) (B) only that portion of the stock issued on or after October 1, 1942, will be considered as having been issued before October 1, 1942, the par or stated value of which does not exceed the par, stated, or face value of such bonds, debentures, or other preferred stock which the new stock was issued to refund or replace. In such case no shares of the new stock issued on or after October 1, 1942, shall be earmarked in determining the credit allowable under section 26 (h) but the appropriate allocable portion of the total amount of dividends paid on such stock will be considered as having been paid on stock which was issued before October 1, 1942.

(4) The provisions of section 26 (h) (2) (B) may be illustrated by the following example:

Example. A public utility has outstanding 1,000 bonds which were issued before October 1, 1942, and each of which has a face value of $100. On or after October 1, 1942, each of such bonds is retired in exchange for 1$\frac{1}{10}$ shares of stock issued on or after October 1, 1942, and having a par value of $100 per share. Only $\frac{10}{11}$ of the dividends paid on the stock thus issued in exchange for the bonds will be considered as having been paid on stock which was issued before October 1, 1942. Likewise, if stock which is issued on or after October 1, 1942, has no par value but a stated value of $50 per share and such stock is issued in a ratio of three shares to one share to refund or replace preferred stock having a par value of $100 per share, only two-thirds of the dividends paid on the new shares of stock will be considered as having been paid on stock which was issued before October 1, 1942.

(5) Whether or not stock issued on or after October 1, 1942, was issued to refund or replace bonds or debentures issued prior to October 1, 1942, or to refund or replace other preferred stock, is in each case a question of fact. Among the factors to be considered is whether such stock is new in an economic sense to the corporation or whether it was issued merely to take the place, directly or indirectly, of bonds, debentures, or other preferred stock of such corporation. It is not necessary that the new stock be issued in exchange for such bonds, debentures, or other preferred stock. The mere fact that the bonds, debentures, or other preferred stock remain in existence for a short period of time after the issuance of the new stock (or were retired before the issuance of the new stock) does not necessarily mean that such new stock was not issued to refund or replace such bonds, debentures, or other preferred stock. It is necessary to

consider the entire transaction, including the issuance of the new stock, the date of such issuance, the retirement of the old bonds, debentures, or preferred stock, and the date of such retirement, in order to determine whether such new stock really was issued to take the place of bonds, debentures, or other preferred stock of the corporation or whether it represents something essentially new in an economic sense in the corporation's financial structure. If, for example, a public utility, which has outstanding bonds issued prior to October 1, 1942, issues new stock on March 1, 1944, in order to secure funds with which to retire such bonds and with the money paid in for such stock retires the bonds on April 1, 1944, such stock may be considered as having been issued to refund or replace bonds issued prior to October 1, 1942. Whether the money used to retire the bonds can be traced back and identified as the money paid in for the stock will have evidentiary value, but will not be conclusive, in determining whether the stock was issued to refund or replace the bonds. Similarly, whether the amount of money used to retire the bonds was smaller than, equal to, or greater than that paid in for the stock, or whether the entire issue of bonds is retired, will be important, but not decisive, in making such determination.

(6) Stock issued on or after October 1, 1942, by a corporation to refund or replace bonds or debentures of a second corporation which were issued prior to October 1, 1942, or to refund or replace other preferred stock of such second corporation, may be considered as having been issued prior to October 1, 1942, if such new stock was issued (1) in a transaction which is a reorganization within the meaning of section 112 (g) (1) or (2) in a transaction to which section 112 (b) (10) relating to reorganization of certain insolvent corporations, or so much of section 112 (d) or (e) as relates to section 112 (b) (10) is applicable; or (3) in a transaction which is subject to the provisions of Supplement R, relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission. Whether the stock actually was issued to refund or replace bonds or debentures of the second corporation issued prior to October 1, 1942, or to refund or replace preferred stock of such second corporation, shall be determined under the same principles as if only one corporation were involved. A corporation may issue stock to refund or replace its own bonds, debentures, or other preferred stock in a transaction which is a reorganization within the meaning of section 112 (g) (1) in a transaction to which section 112 (b) (10) or so much of section 112 (d) or (e) as relates to section 112 (b) (10) is applicable, or in a transaction which is subject to the provisions of Supplement R. The provisions of this paragraph (c) in addition, are applicable in case a corporation issues stock on or after October 1, 1942, to refund or replace its own bonds, debentures, or other preferred stock even though the issuance of such stock may not fall within one of the categories enumerated above.

(7) Even though stock issued on or after October 1, 1942, is considered as having been issued prior to October 1, 1942, by reason of having been issued to refund or replace bonds or debentures issued prior to October 1, 1942, or to refund or replace other preferred stock, such stock will not be deemed to be preferred stock within the meaning of section 26 (h) (2) (B), and no credit will be allowable in respect of dividends paid on such stock, unless the stock fulfills all the other requirements of a preferred stock set forth in section 26 (h) (2) (B) and in this paragraph.

§ 39.26 (i) *Statutory provisions; credits of corporations; percentage of normal-tax net income of Western Hemisphere trade corporations.*

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—* * *

(i) *Western Hemisphere trade corporations.* In the case of a Western Hemisphere trade corporation (as defined in section 109)—

(1) *Calendar year 1951.* * * *

(2) *Taxable years beginning after March 31, 1951, and before April 1, 1954.* In the case of a taxable year beginning after March 31, 1951, and before April 1, 1954, an amount equal to 27 per centum of its normal-tax net income computed without regard to the credit provided in this subsection.

(3) *Taxable years beginning after March 31, 1954.* In the case of a taxable year beginning after March 31, 1954, an amount equal to 30 per centum of its normal-tax net income computed without regard to the credit provided in this subsection.

[Sec. 26 (i) as added by sec. 122 (c), Rev. Act 1950; amended by sec. 202 (b), Excess Profits Tax Act 1950; sec. 122 (c), Rev. Act 1951]

§ 39.26 (i)-1 *Credit of Western Hemisphere trade corporations.* A credit is provided in section 26 (i) for Western Hemisphere trade corporations as defined in section 109. The credit is an amount equal to the following percent of its normal-tax net income for the taxable year computed without regard to such credit:

	Percent
For taxable years beginning before Apr. 1, 1954	27
For taxable years beginning after Mar. 31, 1954	30

For taxable years beginning before April 1, 1954, and ending after March 31, 1954, see § 39.108-2.

§ 39.27 (a) *Statutory provisions; corporation dividends paid credit; definition.*

SEC. 27. *Corporation dividends paid credit*—(a) *Definition in general.* As used in this chapter 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), (4) * * * [Applicable only to taxable years beginning before January 1, 1940.]

[Sec. 27 (a) as amended by sec. 222 (a), Rev. Act 1939]

§ 39.27 (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:

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

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

§ 39.27 (b) *Statutory provisions; corporation dividends paid credit; basic surtax credit.*

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

(b) *Basic surtax credit.* As used in this chapter 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) 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 (A) the section 102 net income for the taxable year, in the case of the tax imposed by section 102; (B) the Supplement P net income for the taxable year, in the case of the computations required under Supplement P; or (C) the Subchapter A net income for the taxable year, in the case of the tax imposed under Subchapter A.

[Sec. 27 (b) as amended by sec. 132 (b), Rev. Act 1942]

§ 39.27 (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 credit under section 26 (h) (relating to the credit for dividends paid on certain preferred stock of certain public utility corporations) and less the amount allowable as a deduction under section 121 (relating to the deduction of dividends paid on certain preferred stock of certain banks and trust companies)

(a) The dividends paid during the taxable year (subject to the qualifications, limitations, and exceptions provided in section 27 (d) to 27 (i), 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

(b) The smaller of the following:

(1) The sum of the net operating loss credit for the preceding taxable year provided in section 26 (c) (1) and the bank affiliate credit provided in section 26 (d).

(2) (i) The section 102 net income for the taxable year, in the case of tax imposed by section 102; (ii) the Supplement P net income for the taxable year, in the case of computations required under Supplement P or (iii) the subchapter A net income for the taxable year, in the case of tax imposed under subchapter A of chapter 2.

§ 39.27 (b)-2 *Dividends paid*—(a) *When dividends are considered paid.* (1)

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.

(2) 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.

(3) 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.

(4) 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.

(5) 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.

(6) 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, consitutes prima facie evidence of the payment of the dividend.

(7) 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.

(8) 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 (i) a copy of the dividend resolution; and (ii) a concise statement of the pertinent facts relating to the payment of the dividend, clearly specifying (*a*) the medium of payment and (*b*) 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.

§ 39.27 (c) *Statutory provisions; corporation dividends paid credit; dividend carry-over.*

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 Subchapter A net income for such year, and further reduced by the amount, if any, by which the Subchapter A 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 over the Subchapter A 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 Subchapter A net income for such year. In the case of a preceding taxable year referred to in this subsection, the Subchapter A net income shall be determined as if the corporation was, under the law applicable to such taxable year, a personal holding company.

[Sec. 27 (c) as amended by sec. 132 (c), Rev. Act 1942]

§ 39.27 (c)-1 *Dividend carry-over* (a) The dividend carry-over to a given taxable year is computed as follows:

(1) If the basic surtax credit for the first preceding taxable year exactly equals the subchapter A 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 subchapter A net income for such year.

(2) If the basic surtax credit for the first preceding taxable year exceeds the subchapter A 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 subchapter A net income for such year.

(3) If the basic surtax credit for the first preceding taxable year is less than the subchapter A 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 subchapter A net income for such year reduced by the excess of the subchapter A 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 over the subchapter A net income for such year.

(b) In computing the dividend carry-over the subchapter A net income of any preceding taxable year shall be determined as if the corporation was, under the law applicable to such taxable year, a personal holding company.

(c) 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.

(d) 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 subchapter A net income of $150,000 and a basic surtax credit of $225,000 for 1949. For 1950 its subchapter A net income is $200,000 and its basic surtax credit is $350,000, and for 1951 its subchapter A net income and its basic surtax credit are each $175,000. Its dividend carry-over to 1952 is $150,000, computed as follows:

(1) Basic surtax credit for 1950	$350,000
(2) Less subchapter A net income for 1950	200,000
(3) Dividend carry-over to 1952 ((1) minus (2))	150,000

Since the basic surtax credit for 1951 exactly equals the subchapter A net income for that year, neither that year nor the year 1949 need be taken into account. The preceding taxable year (1951) is taken into account only if the basic surtax credit for such year exceeds the subchapter A net income for such year or if the subchapter A net income for such year exceeds the sum of the basic surtax credit for such year and the excess of the basic surtax credit for the third preceding taxable year (1949) over the subchapter A net income for such year. The third preceding taxable year (1949) is taken into account only if the subchapter A net income for the first preceding taxable year (1951) 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 (1950).

Example (2). The Y Corporation, which makes its income tax returns on the calendar year basis, has subchapter A net income of $100,000 and a basic surtax credit of $150,000 for 1949. For 1950 its subchapter A net income is $50,000 and its basic surtax credit is $75,000, and for 1951 its subchapter A net income and its basic surtax credit are $25,000 and $100,000, respectively. Its dividend carry-over to 1952 is $100,000, computed as follows:

Year 1950		
(1) Basic surtax credit	$75,000	
(2) Less subchapter A net income	50,000	
(3) Excess of basic surtax credit over subchapter A net income		$25,000
Year 1951		
(4) Basic surtax credit	$100,000	
(5) Less subchapter A net income	25,000	
(6) Excess of basic surtax credit over subchapter A net income		75,000
(7) Dividend carry-over to 1952 (sum of (3) and (6))		100,000

For the reason why the year 1949 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 a subchapter A net income of $90,000, and a basic surtax credit of $150,000 for 1949. For 1950 its subchapter A net income is $60,000 and its basic surtax credit is $160,000, and for 1951 its subchapter A net income and its basic surtax credit are $120,000 and $25,000, respectively. Its dividend carry-over to 1952 is $65,000, computed as follows:

Year 1950				
(1) Basic surtax credit			$160,000	
(2) Less subchapter A net income			60,000	
(3) Excess of basic surtax credit over subchapter A net income				$100,000
Year 1951				
(4) Subchapter A net income			$120,000	
(5) Basic surtax credit		$25,000		
Year 1949				
(6) Basic surtax credit	$150,000			
(7) Less subchapter A net income	90,000			
(8) Excess of basic surtax credit over subchapter A net income		60,000		
(9) Sum of (5) and (8)			85,000	
(10) Excess of subchapter A net income for the first preceding taxable year (1951)				35,000
(11) Dividend carry-over to 1952				65,000

§ 39.27 (d) *Statutory provisions; corporation dividends paid credit; dividends in kind.*

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.

§ 39.27 (d)-1 *Dividends in kind.* (a) 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.

(b) As used in this section, 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.

(c) The application of section 27 (d) may be illustrated by the following example:

Example. The S Corporation, in 1944, purchased stock of the Y Corporation for $100,000. In 1952 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 1952 the S 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 1952 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 1952	$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 1952 with respect to such stock.

§ 39.27 (e) *Statutory provisions; corporation dividends paid credit; dividends in obligations of the corporation.*

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 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.

§ 39.27 (e)-1 *Dividends in obligations of the corporation.* (a) 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, 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 al-

lowance regardless of the identity of the holders of the obligations at the time of their redemption.

(b) As used in this section, the term "obligations" 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. As used in this section, the term "redeemed" 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.

(c) 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 1946, 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 1946 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 1946 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 1952. 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 1946 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 1952, 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 1946	75,000
Difference	25,000
Less bond discount allowed as a deduction in computing net income	15,000
Amount treated as dividend paid in 1952	10,000

§ 39.27 (f) *Statutory provisions; corporation dividends paid credit; taxable stock dividends.*

SEC. 27. *Corporation dividends 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 payment.

§ 39.27 (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 the form of 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 payment of the dividend. As to a distribution by a corporation of its own capital stock held as an investment, see § 39.27 (d)-1.

§ 39.27 (g) *Statutory provisions; corporation dividends paid credit; distributions in liquidation.*

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

(g) *Distributions 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.

§ 39.27(g)-1 *Dividends paid credit for distributions in liquidation—*(a) *Distributions which diminish earnings or profits.* (1) 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 Internal Revenue Code, 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 Code as one constituting in part a distribution of, and being properly chargeable to, earnings or profits, if—

(i) Under the provisions of section 115 (c) the amounts distributed in liquidation are treated as received in payment in exchange for the stock; and

(ii) 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.

(2) On the other hand, certain transactions described in sections 112 and 115 are treated, for the purposes of the Internal Revenue Code, 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 Code 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 Code. No allowance for dividends paid is permissible with respect to such transactions.

(b) *Amount properly chargeable to earnings or profits.* (1) In the case of a distribution in liquidation with respect to which an allowance for dividends paid is permissible (see paragraph (a) of this section) 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 the purposes of this section, 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.

(2) The application of subparagraph (1) 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 $100 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, 1952, 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, 1952, 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 Internal Revenue Code, 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.* (1) 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 part of its return for the taxable year involved (i) 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 (ii) 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.

(2) The provisions of subparagraph (1) 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, 1952. 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 1952 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 March 31, 1953, 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, 1952, $25,000; September 15, 1952, $25,000; December 15, 1952, $25,000; and March 15, 1953, $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, 1953, 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).

§ 39.27 (h) *Statutory provisions; corporation dividends paid credit; preferential dividends.*

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.

§ 39.27 (h)-1 *Preferential distributions.* (a) 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 section 27 (h) 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. As used in this section, the term "distribution" includes a dividend as defined in section 115, and a distribution in liquidation referred to in section 27 (g)

(b) The application of the provisions of section 27 (h) 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, 1952, declared a dividend of $5 a share payable in cash on August 1, 1952, to A. On September 15, 1952, it declared a dividend of $5 a share payable in cash on October 1, 1952, to B, C, and D. No allowance for dividends paid for the taxable year 1952 is permitted to the M Corporation with respect to any part of the dividends paid on August 1, 1952, and October 1, 1952.

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 1952 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 allowance for dividends paid is permissible 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, 1952, 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.

§ 39.27 (i) *Statutory provisions; corporation dividends paid credit; nontaxable distributions.*

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 chapter for the period in which the distribution is made, such part shall not be included in computing the basic surtax credit.

§ 39.27 (i)-1 *Nontaxable distributions.* (a) No allowance for dividends paid is permitted with respect to any part of the distribution by a corporation to its shareholders which is—

(1) 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 corpo-

ration accumulated after February 28, 1913, under section 27 (g)

(2) 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

(3) 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))

(b) The effect of sections 27 (h) and (i) 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 chapter 1 for the period in which the distribution is made, receives a taxable dividend as a result of the distribution. (See also section 27 (g).)

(c) The application of section 27 (i) may be illustrated by the following example:

Example. A, B, and C are shareholders of the Y Corporation, a personal holding company, which makes its returns on the basis of a fiscal year ending July 31. A is an educational corporation exempt from income tax under section 101. On July 15, 1952, the Y Corporation distributed $90,000 in cash to its shareholders, $30,000 to each. The Y Corporation had a deficit in earnings and profits as of the beginning of its taxable year in the amount of $200,000, but had a subchapter A net income for the taxable year in the amount of $90,000. Its earnings and profits for the taxable year were only $50,000. It was entitled under section 26 (c) (1) to a net operating loss credit of $30,000. The distributions from the Y Corporation will constitute a taxable dividend in the hands of B and C only to the extent of $40,000, $20,000 to each (the amount of $30,000 reduced by a proportionate part of the net operating loss credit.) See § 39.115 (a)-1. The Y Corporation, accordingly, will be entitled to an allowance for dividends paid in the amount of $70,000 with respect to the distribution on July 15.

§ 39.28 (a) *Statutory provisions; consent dividends credit; definitions.*

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.

(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.

(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.

(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.

(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).

(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.

§ 39.28 (a)-1 *Consent stock.* (a) As defined in section 28 (a) (1) the term "consent stock" includes what is generally known as common stock. It also includes participating preferred stock, the participation rights of which are unlimited.

(b) The application of section 28 (a) (1) may be illustrated by the following example:

Example. If in the case of the 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.

§ 39.28 (a)-2 *Preferred dividends.* (a) As defined in section 28 (a) (2) the term "preferred dividend" 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.

(b) The application of section 28 (a) (2) may be illustrated by the following example:

Example. 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.

§ 39.28 (a)-3 *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.

§ 39.28 (a)-4 *Consent distribution.* (a) As defined in section 28 (a) (4), the term "consent distribution" 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.

(b) 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, 1952, the corporation distributes to A $5 per share, or $1,000. On December 31, 1952, B executes a consent to include $1,500 in his gross income as a taxable dividend. At the beginning of 1952 the corporation had no accumulated earnings or profits. For the taxable year 1952 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.

§ 39.28 (a)-5 *Partial distribution.* (a) As defined in section 28 (a) (5), the term "partial distribution" does not include preferred dividends even though payable on consent stock.

(b) 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, 1952, 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.

§ 39.28 (a)-6 *Preferential distribution.* (a) 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.

(b) 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, 1952, 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, 1952, 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.

§ 39.28 (b) *Statutory provisions; consent dividends credit; corporations not entitled to credit.*

SEC. 28. *Consent dividends credit.* * * *

(b) *Corporations not entitled to credit.* A corporation shall not 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.

§ 39.28 (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 § 39.27 (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.

§ 39.28 (b)-2 *Liquidation of consent stock.* (a) (1) 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.

(2) The application of section 28 (b) (2) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has outstanding on January 1, 1952, 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 stock of $6 per share. On April 1, 1952, 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.

(b) 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.

§ 39.28 (c) *Statutory provisions; consent dividends credit; allowance.*

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.

§ 39.28 (c)-1 *Amount of consent dividends credit.* (a) The consent dividends credit forms part of the basic surtax credit. 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.

(b) 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 1952 amount to $8,000, there being at the beginning of such year 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, 1952. 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, 1952, 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.

§ 39.28 (d) *Statutory provisions; consent dividends credit; shareholders' consents.*

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 (in accordance with regulations prescribed by the Commissioner with the approval of the Secretary) with its return for such year, or within one year after the date of enactment of the Revenue Act of 1942, in the case of a corporation which is a personal holding company for the taxable year with respect to which it claims the benefits of this section, signed consents made under oath by persons who were shareholdz-

ers, 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.

[Sec. 28 (d) as amended by sec. 186 (e) (1), Rev. Act 1942]

§ 39.28 (d)–1 *Making and filing of consents.* (a) A consent shall be made in duplicate on Form 972 in accordance with this section 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. Form 972 shall contain or be verified by a written declaration that it is made under the penalties of perjury 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.

(b) 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. 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 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. Form 973 shall contain or be verified by a written declaration that it is made under the penalties of perjury.

(c) In the event that any consent filed by the corporation is made by a shareholder to whom the payment of a dividend in cash on the last day of the taxable year of the corporation would have made it necessary for the corporation 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:

(1) Cash;

(2) United States postal money order;

(3) 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;

(4) A cashier's check of a domestic bank; or

(5) 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.

§ 39.28 (d)–2 *Consent distribution must be nonpreferential.* The application of section 28 (d) (3) may be illustrated by the following example:

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, 1952, the corporation distributes $600 to B and $100 to A. On December 31, 1952, 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.

§ 39.28 (e) *Statutory provisions; consent dividends credits; consent distribution as part of entire distribution.*

SEC. 28. *Consent dividends credit.* * * *

(e) *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 chapter, 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.

§ 39.28 (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 chapter 1. Thus, such rule is to be applied to determine whether a partial distribution is a preferential dividend under section 27 (h)

§ 39.28 (f) *Statutory provisions; consent dividends credit; taxability of amounts specified in consents.*

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.

§ 39.28 (f)–1 *Taxability of amounts specified in consents.* (a) 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.

(b) The ground upon which a consent dividends credit is denied the corporation does not affect the taxability of a shareholder whose consent has been filed for 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 amount of 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 (1) preferred dividends have not been paid, (2) part or all of the consent stock has been in a state of liquidation at any time during the taxable year, (3) the distribution of which the consent distribution is a part is preferential, (4) 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 (5) payment has not been made as required by section 28 (d) (5) and § 39.28 (d)-1.

§ 39.28 (g) *Statutory provisions; consent dividends credit; corporate shareholders.*

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.

§ 39.28 (g)-1 *Treatment of amount specified in consent of corporate shareholder* (a) 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.

(b) The effect of a corporate shareholder's consent upon the computation of its earnings and profits may be illustrated by the following example:

Example. The X Corporation has one shareholder, the Y Corporation, whose consent to include $10,000 in its gross income for the calendar year 1952 has been duly made and filed. The earnings and profits of the X Corporation for the calendar year 1952 amount to only $8,000, there being at the beginning of such year 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 1952 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.

§ 39.28 (h)-(i) *Statutory provisions; consent dividends credit; basis of stock in hands of shareholders; effect on capital account of corporation.*

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.

§ 39.28 (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 1952. 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 1952, however, amount to only $80, there being at the beginning of such year 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:

(a) In the case of the X Corporation—

(1) Its consent dividends credit is $40, being 80 percent of the amount specified in A's consent;

(2) 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;

(3) 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.

(b) In the case of A—

(1) A is taxable on $50 as a dividend;

(2) The basis of his stock is increased by $40, his pro rata share, i. e., all, of the consent dividends credit.

(c) In the case of B—

(1) B is taxable on $40 as a dividend;

(2) The basis of his stock is reduced by $10.

§ 39.28 (j) *Statutory provisions; consent dividends credit; amounts not included in shareholder's return.*

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.

CREDITS AGAINST TAX

§ 39.31-35 *Statutory provisions; credits against tax; taxes of foreign countries and possessions of United States; cross references; tax withheld on wages.*

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 (other than the tax imposed by subchapter E, relating to tax on self-employment income), to the extent provided in section 131.

[Sec. 31 as amended by sec. 203 (d) (3), Social Security Act Amendments 1950]

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 chapter for other taxable years, see section 322.

SEC. 34. *Credits against victory tax.*

[Repealed by sec. 108 (c) (2), Rev. Act 1943]

SEC. 35. *Credit for tax withheld on wages.* The amount deducted and withheld as tax under Subchapter D of Chapter 9 during any calendar year upon the wages of any individual shall be allowed as a credit to the recipient of the income against the tax imposed by this chapter for the taxable year beginning in such calendar year. If more than one taxable year begins in any such calendar year uch amount shall be allowed as a credit against the tax for the last taxable year so beginning.

[Sec. 35 as added by sec. 172 (f) (2), Rev. Act 1942; amended by sec. 3, Current Tax Payment Act 1943]

§ 39.35-1 *Credit for tax withheld on wages.* (a) The tax deducted and withheld at the source upon wages under subchapter D of chapter 9 is allowable as a credit against the tax imposed by chapter 1 upon the recipient of the income. If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer. See section 322. For the purpose of the credit, the recipient of the income is the person subject to tax imposed under chapter 1 upon the wages from which the tax was withheld. For instance, if a husband and wife domiciled in a State recognized as a community property State for Federal tax purposes make separate returns, each reporting for income tax purposes one-half of the wages received by the husband, each spouse is entitled to one-half of the credit allowable for the tax withheld at source with respect to such wages.

(b) The credit shall be allowed against the tax imposed by chapter 1 for the taxable year of the recipient of the income which begins in such calendar year. If such recipient has more than one taxable year beginning in such calendar year, the credit shall be allowed against the tax for the last taxable year so beginning.

§ 39.35-2 *Credit for "special refunds" of employee social security tax*—(a) *In general.* (1) In the case of an employee receiving wages from more than one em-

ployer during the calendar year, amounts may be deducted and withheld as employee social security tax under section 1400 with respect to more than $3,600 wages (for example, on $4,500 if the employee is paid $2,500 by one employer and $2,000 by another) Section 1401 (d) permits, under certain conditions, a so-called "special refund" of the amount of such employee social security tax deducted and withheld with respect to wages in excess of $3,600 by reason of the employee working for more than one employer during the calendar year.

(2) An employee who is entitled to a special refund of employee tax with respect to wages received during a calendar year and who is also required to file an income tax return for such calendar year (or for his last taxable year beginning in such calendar year) may obtain the benefits of such special refund only by claiming credit for such special refund in the same manner as if such special refund were an amount deducted and withheld as income tax at the source under subchapter D of chapter 9. The credit with respect to a special refund is not allowable unless the return, amended return, or claim for refund, on which the special refund is claimed, is filed within two years after the calendar year in which payment is made of the wages with respect to which the special refund of tax is claimed. See section 1401 (d) (3) and (4) and § 408.802 (c) of this chapter (Regulations 128) pertaining to tax under subchapter A of chapter 9 (Federal Insurance Contributions Act) For special provisions for claiming special refunds in the case of employees not required to file income tax returns, see § 408.802 (c) (3) of this chapter (Regulations 128)

(3) The amount of the special refund allowed as a credit shall be considered as an amount deducted and withheld as income tax at the source under subchapter D of chapter 9. If the amount of such special refund when added to amounts deducted and withheld as income tax under subchapter D of chapter 9 exceeds the taxes imposed by chapter 1, the amount of the excess constitutes an overpayment of income tax under chapter 1, and interest on such overpayment is allowed to the extent provided under section 3771 upon an overpayment of income tax resulting from a credit for income tax withheld at source. See section 322 (a) (2) and (4)

(b) *Federal and State employees.* The provisions of this section shall apply to the amount of a special refund (under section 1401 (d) (4) (A)) allowable to an employee of a Federal agency or a wholly owned instrumentality of the United States, and to the amount of a special refund (under section 1401 (d) (4) (B)) allowable to an employee of any State or political subdivision thereof (or any instrumentality of any one or more of the foregoing)

ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

§ 39.41 *Statutory provisions; accounting periods and methods of accounting; general rule.*

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).

§ 39.41-1 *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 expenditure 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 §§ 39.42-1 to 39.42-3, inclusive.) 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.

§ 39.41-2 *Bases of computation and changes in accounting methods.* (a) 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 §§ 39.42-2 and 39.42-3.) 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 § 39.22 (c)-5.)

(b) The true income, computed under the Internal Revenue Code 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.

(c) 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 section, 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 §§ 39.22 (c)-1 to 39.22 (c)-8, inclusive) 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 § 39.42-4) 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 §§ 39.22 (a)-7 and 39.23 (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 section 22 (d) and §§ 39.22 (d)-1 to 39.22 (d)-7, inclusive, with respect to changing to the last-in first-out method of inventorying goods.

(d) Section 44 contains special provisions for reporting the profit derived from the sale of property on the installment plan.

(e) 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 §§ 39.44-1 and 39.44-3, 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.

§ 39.41-3 *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 § 39.54-1.) Among the essentials are the following:

(a) 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 §§ 39.22 (c)-1 to 39.22 (c)-8, inclusive)

(b) 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

(c) 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.

§ 39.41-4 *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 § 39.46-1.

§ 39.42 *Statutory provisions; accounting periods and methods of accounting; period in which items of gross income included.*

SEC. 42. *Period in which items of gross income included*—(a) *General rule.* 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 whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued only by reason of the death of the taxpayer shall not be included in computing net income for the period in which falls the date of the taxpayer's death.

(b) *Noninterest-bearing obligations issued at discount.* If, in the case of a taxpayer owning any noninterest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals or owning an obligation described in paragraph (2) of subsection (d), the increase in the redemption price of such obligation occurring in the taxable year does not (under the method of accounting used in computing his net income) constitute income to him in such year, such taxpayer may, at his election made in his return for any taxable year beginning after December 31, 1940, treat such increase as income received in such taxable year. If any such election is made with respect to any such obligation, it shall apply also to all such obligations owned by the taxpayer at the beginning of the first taxable year to which it applies and to all such obligations thereafter acquired by him and shall be binding for all subsequent taxable years, unless upon application by the taxpayer the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to change to a different method. In the case of any such obligations owned by the taxpayer at the beginning of the first taxable year to which his election applies, the increase in the redemption price of such obligations occurring between the date of acquisition (or, in the case of an obligation described in paragraph (2) of subsection (d), the date of acquisition of the series E bond involved) and the first day of such taxable year shall also be treated as income received in such taxable year.

(c) *Short-term obligations issued on discount basis.* In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of.

(d) *Matured United States savings bonds.* In the case of a taxpayer who—

(1) Holds a series E United States savings bond at the date of maturity, and

(2) Pursuant to regulations prescribed under the Second Liberty Bond Act retains his investment in the maturity value of such series E bond in an obligation, other than a current income obligation, which matures not more than ten years from the date of maturity of such series E bond,

the increase in redemption value (to the extent not previously includible in gross income) in excess of the amount paid for such series E bond shall be includible in gross income in the taxable year in which the obligation is finally redeemed or in the taxable year of final maturity, whichever is earlier. The provisions of this subsection shall not apply to a corporation, and shall not apply in the case of any taxable year for which the taxpayer's net income is computed upon the basis of the accrual method of accounting or for which an election made by the taxpayer under subsection (b) is applicable.

[Sec. 42 as amended by secs. 114, 115 (a), Rev. Act 1941; sec. 134 (a), Rev. Act 1942; sec. 2, Pub. Law 12 (82d Cong.).]

§ 39.42-1 *When included in gross income*—(a) *In general.* Except as otherwise provided in section 42, 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 §§ 39.41-1 to 39.41-3, inclusive. As to income from noninterest-bearing obligations issued at discount, see § 39.42-6, and as to income from short-term obligations issued on a discount basis, see § 39.42-7. 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 § 39.23 (k)-1. Except as otherwise stated in this paragraph, 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. In the case of a termination of a war contract as defined by section 3 of the Contract Settlement Act of 1944, 41 U. S. C. 103 (or the termination of any other Government contract as to which the right to compensation is definitely fixed and the measure thereof is determinable with reasonable accuracy) if the return is rendered on a basis other than cash receipts and disbursements, compensation for the termination shall, unless a different method of reporting is prescribed or approved by the Commissioner, constitute income for the taxable year in which falls the effective date of the termination, except that if any part of the compensation is attributable to cost, expenses, or losses incurred in a subsequent year such part of the compensation shall be returned as income for the subsequent year. As to amounts received pursuant to an award under the order issued on December 4, 1950,

under the Railway Mail Pay Act of 1916 by the Interstate Commerce Commission, as compensation for the transportation of mail during 1950 and prior years, see section 611 (a) of the Revenue Act of 1951.

(b) *Last taxable year of decedent.* For the taxable year in which falls the date of the death of a taxpayer, there shall be included in computing net income of the taxpayer only amounts properly includible under the approved method of accounting followed by the taxpayer, or, if the taxpayer followed no such method, only amounts received during such year. However, if the taxpayer followed the accrual method of accounting, amounts accrued only by reason of his death shall not be included in computing net income for such year, except that, if the taxpayer was a member of a partnership, his share of the partnership income for the partnership year ending with its dissolution on account of his death shall be included in computing his net income. The approved accounting practice of the partnership in computing its income shall not be changed by reason of the taxpayer's death. Thus, if the partnership computed its income on the basis of cash receipts and disbursements, the partnership income for the year ending with the dissolution, a distributive share of which is included in the taxpayer's income, shall be so computed. If the partnership used the accrual method of accounting, its income shall be computed according to such practice. For example, if a law partnership keeping its books on the accrual method of accounting is entitled to certain contingent fees which are accrued only upon the completion of the cases involved, such partnership will compute its income for the year ending with its dissolution on account of the death of the taxpayer without accruing, on account of the death of the partner at such time, any such contingent fees in uncompleted cases. Under section 126, any distribution by the partnership to the estate or a beneficiary of the deceased partner out of such fees will be income to such estate or person. There must also be included in computing net income for the taxable year in which falls the date of death of a taxpayer the gain described in section 44 (d) relating to gain upon the disposition of installment obligations, except as otherwise provided in that section. See § 39.44-5. This amount must be included in computing net income regardless of the method of accounting followed by the taxpayer.

§ 39.42-2 *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.

§ 39.42-3 *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.

§ 39.42-4 *Long-term contracts.* (a) 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 section, the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. 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:

(1) 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.

(2) 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.

(b) A taxpayer may change his method of accounting to accord with subparagraph (1) or (2) of paragraph (a) of this section only after permission is secured from the Commissioner as provided in § 39.41-2.

§ 39.42-5 *Subtraction for redemption of trading stamps.* (a) 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:

(1) The total issue of stamps during each year;

(2) The total stamps redeemed in each year; and

(3) 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.

(b) 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.

§ 39.42–6 *Noninterest-bearing obligations issued at discount.* (a) If a taxpayer owns any noninterest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals, and if the increase in redemption price of such obligation occurring in the taxable year does not constitute income for such year under the method of accounting used in computing his net income, the taxpayer may, at his election, treat such increase as constituting income for the year in which it occurs rather than in the year in which the obligation is disposed of, redeemed, or paid at maturity. The election must be made in the taxpayer's return and may be made for any taxable year. The election shall apply also to all other obligations of the type described in this section owned by the taxpayer at the beginning of the first taxable year to which the election applies and to those thereafter acquired by him. It shall apply to the taxable year for which such return is filed, and shall be binding for all subsequent taxable years unless upon application by the taxpayer the Commissioner permits the taxpayer, subject to such conditions as the Commissioner deems necessary, to change to a different method of reporting income from such obligations. Although the election, once made, is binding upon the taxpayer, it does not apply to a transferee of such taxpayer.

(b) In any case in which an election is made under this section, the amount considered to accrue in any taxable year to which the election applies is measured by the actual increases in the redemption price occurring in that year. Such amount shall not be considered to accrue ratably between the dates on which the redemption price changes. Thus, if two dates on which the redemption price increases fall within a taxable year and if the redemption price increases in the amount of 50 cents on each such date, the amount deemed to accrue in that year would be $1. If at the beginning of the first taxable year to which the election applies the taxpayer owns noninterest-bearing bonds of the prescribed character acquired prior thereto, he is required to report in such year, in addition to the increases in the redemption price actually falling within that year, the total of the increases in such price occurring between the date of his acquisition and the beginning of such year.

Example. Throughout the calendar year 1952, a taxpayer who makes his returns on the calendar year basis and computes his net income on the cash receipts and disbursements basis holds United States savings bonds, Series E, having a maturity value of $5,000, which he purchased on January 1, 1947, for $3,750. The taxpayer holds no other obligation of the type described in this section. In his return for 1952 the taxpayer elects to treat the increase in the redemption price of such bonds occurring in such year as income to him for such year. Under this section he is required to report with respect to such bonds as subject to both normal tax and surtax $400, of which $300 represents the increase in the redemption price before 1952 and $100 represents the increase in the redemption price in 1952.

§ 39.42–7 *Short-term obligations issued on discount basis.* In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of. Accordingly, if a taxpayer who computes his net income on the accrual basis purchases upon issuance a United States Treasury bill and holds it until maturity, the entire amount of the discount at which the bill was originally sold accrues on the date of maturity; and if such a taxpayer holds a United States Treasury bill for a period less than its life, the portion of the original discount attributable to such period accrues only on the date on which he sells or otherwise disposes of the bill or receives payment at maturity. The original discount or the portion of such discount, as the case may be, is includible only in the gross income for the taxable year in which the taxpayer sells or otherwise disposes of the bill or receives payment at maturity. For examples illustrating rules for computation of income from sale or other disposition of obligations of the type described in this section, see § 39.117 (a)–1.

§ 39.43 *Statutory provisions; accounting periods and methods of accounting; period for which deductions and credits taken.*

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 chapter 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 whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued as deductions and credits only by reason of the death of the taxpayer shall not be allowed in computing net income for the period in which falls the date of the taxpayer's death.

[Sec. 43 as amended by sec. 134 (b), Rev. Act 1942]

§ 39.43–1 *"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 chapter 1 (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 Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

(b) In any case in which, owing to monetary, exchange, or other restrictions imposed by a foreign country, an amount otherwise constituting gross income for the taxable year from sources without the United States is not includible in gross income of the taxpayer for that year, the deductions and credits charged against the amount so restricted shall be deemed to have been "paid or accrued" or "paid or incurred" proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income. See § 39.131 (d)–1 for the treatment of foreign income tax imposed with respect to such amount as a basis of credit for foreign income tax in such cases.

(c) The provisions of paragraphs (a) and (b) of this section are in general applicable with respect to the taxable year during which the taxpayer dies. However, if the taxpayer followed the accrual method of accounting, there shall be included in computing net income for such year no amount accrued solely by reason of his death other than his distributive share of the losses of a partnership for the year ending with the dissolution of the partnership on account of his death. No change in the accounting practice of the partnership shall be made because of the taxpayer's death when the income and losses of the partnership are computed for the year ending with the dissolution of the partnership on account of the partner's death.

§ 39.43–2 *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.

§ 39.44 *Statutory provisions; accounting periods and methods of accounting; installment basis.*

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 payment 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.

§ 39.44-1 *Sale of personal property on installment plan.* (a) Dealers who sell on the installment plan usually adopt one of four ways of protecting themselves in case of default—

(1) By an agreement that title is to remain in the vendor until the purchaser has completely performed his part of the transaction;

(2) 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;

(3) 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

(4) By conveyance to a trustee pending performance of the contract and subject to its provisions.

(b) 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. 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 accounts in such a manner as to enable an accurate computation to be made on such basis in accordance with the provisions of this section.

(c) 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.

(d) 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 § 39.44-5.) 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 § 39.23

(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.

(e) 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.

§ 39.44-2 *Sale of real property involving deferred payments.* (a) Under section 44 deferred-payment sales of real property include (1) 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 (2) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

(b) Such sales, either under paragraph (a) (1) or (2) of this section 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.

(c) 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 §§ 39.44-1 and 39.44-3, and in this section. 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.

§ 39.44-3 *Sale of real property on installment plan.* (a) In transactions included in § 39.44-2 (a) (1) 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.

(b) 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 § 39.44-5.) 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 § 39.23 (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)

(c) 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.

§ 39.44-4 *Deferred-payment sale of real property not on installment plan.* (a) In transactions included in § 39.44-2 (a) (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.

(b) 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 accepts a voluntary reconveyance of the property, in partial or full satisfaction of the unpaid portion of the purchase price, the receipt of the property so reacquired, to the extent of its fair market value at that time, including the fair market value of fixed improvements placed on the property by the purchaser, shall be considered as the receipt of payment on the obligations satisfied. If the fair market value of the property is greater than the basis of the obligations of the purchaser so satisfied (generally, such basis being the fair market value of such obligations previously recognized in computing income) the excess constitutes ordinary income, and if the value of such property is less than the basis of such obligations, the difference may be deducted as a bad debt if uncollectible, except that if the obligations satisfied are securities (as defined in section 23 (k) (3) and section 117 (f)), any gain or loss resulting from the transaction is a capital gain or loss subject to the provisions of section 117. 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. See § 39.23 (k)-3 with respect to property reacquired in a foreclosure proceeding.

(c) 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.

§ 39.44–5 *Gain or loss upon disposition of installment obligations.* (a) 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 Internal Revenue Code unless the disposition is within one of the exceptions made by the Code. 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.

(b) The application of section 44 (d) may be illustrated by the following examples:

Example (1). In 1950 the M Corporation sold a piece of unimproved real estate to B for $20,000. The company acquired the property in 1938 at a cost of $10,000. During 1950 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 1952, 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 1952 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 1952		5,500

Example (2). Suppose in the example given above the M Corporation, instead of selling the notes, distributed them in 1952 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 1952 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 1952	6,500

(c) In the case of a decedent who dies 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 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 received such payment. The bond shall be subject to the approval of the Commissioner, shall be in an amount sufficient in his judgment to insure collection of the tax resulting from the fulfillment of the conditions stated in the bond, and shall be filed at the time of filing the return for the decedent for the year of his death or at such later time as may be specified by the Commissioner. A corporation will not be accepted as a surety on such bond unless the corporation holds a certificate of authority from the Secretary as an acceptable surety on Federal bonds. In lieu of surety or sureties there may be deposited bonds or notes of the United States.

(d) 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.

§ 39.45 *Statutory provisions; accounting periods and methods of accounting; allocation of income and deductions.*

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, deductions, credits, or allowances 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.

[Sec. 45 as amended by sec. 128 (b), Rev. Act 1943]

§ 39.45–1 *Determination of the taxable net income of a controlled taxpayer*—(a) *Definitions.* When used in this section:

(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 Internal Revenue Code or the regulations in this part) 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, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, 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.* (1) 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, deductions, credits, or allowances, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall 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.

(2) Section 45 and this section 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.

(3) 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, credits, or allowances, or any item of gross income, deductions, credits, or allowances, 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, deductions, credits, or allowances. 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.

§ 39.46 *Statutory provisions; accounting periods and methods of accounting; change of accounting period.*

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.

§ 39.46-1 *Change of accounting period*—(a) *Short taxable years ending prior to July 1, 1953.* If a taxpayer (other than a subsidiary corporation required to change its accounting period by reason of the provisions of § 24.14 of this chapter (Regulations 129)) changes his accounting period, he shall make application direct to the Commissioner on Form 1128 at least 60 days prior to the close of the fractional part of the year for which a return would be required to effect the change if the short taxable year ends before July 1, 1953, and, before using the new period for income tax purposes, secure the consent of the Commissioner. If a change of accounting period of a subsidiary is required for income tax purposes under § 24.14 of this chapter (Regulations 129) the information required on Form 1128 shall be furnished by the subsidiary at or before the time of filing the consolidated income tax return. For the due date of returns for fractional parts of a year, see § 39.53-1. Where a timely application is made to compute the net income of an individual taxpayer upon the basis of the same accounting period as that of such individual's spouse, permission so to compute net income will be granted even though such permission will allow the individual and his spouse to reduce their taxes by taking advantage of section 12 (d) (the so-called "income splitting" provision) through the filing of a joint return, so long as no other reason appears which is considered sufficient by the Commissioner for denying such permission. 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.

(b) *Short taxable years ending after June 30, 1953*—(1) *General.* A change of accounting period for income tax purposes requiring a return for a short taxable year ending after June 30, 1953, is authorized, except where inconsistent with section 41, requiring the use of the calendar year basis in certain specific cases, and except as provided in subparagraph (2) of this paragraph, and no application for such change need be filed. To make such a change the taxpayer shall file a tax return on or before the 15th day of the third full calendar month following the close of the short taxable year accompanied by a statement that it is made under the authorization conferred by this section. Once a change of accounting period has been made, the taxpayer shall thereafter make his returns and compute his net income on the basis of the new accounting period.

(2) *Cases in which approval of change of accounting period is required.* The prior approval of the Commissioner will be required before a taxpayer may change his accounting period if any of the following conditions exist:

(i) At any time within the 5 calendar years ending with the calendar year which includes the beginning of the short taxable year required to effect the change of accounting period the taxpayer has changed his accounting period for income tax purposes. For the purpose of this subparagraph a change of accounting period for income tax purposes by a partnership shall be considered as a change by each member thereof and a change by any member shall be deemed to be a change by the partnership. Likewise, a change of accounting period for income tax purposes by a trust shall be considered as a change by each beneficiary thereof and a change by a beneficiary shall be deemed to be a change by the trust.

(ii) The short taxable year required to effect the change of accounting period ends more than 3 months and less than 9 months after the close of the accounting period used by the taxpayer for purposes of filing his income tax return for the previous full taxable year.

(iii) The taxpayer's net income for the short taxable year required to effect the change of accounting period, as annualized in the manner provided in § 39.47-2, is less than 80 percent of the net income of the taxpayer for the full taxable year immediately preceding such short taxable year.

(3) *Illustration.* The application of certain of the foregoing provisions is illustrated by the following example:

Example. X files his income tax returns on a calendar year basis. He desires to change his accounting period during the year 1954 in order to file his returns on a fiscal year basis ending March 31. X has not previously changed his accounting period. His income for the period January 1 through March 31, 1954, when annualized in accordance with § 39.47-2, equals at least 80 percent of his net income for the calendar year 1953. X is authorized to change his accounting period by filing, on or before June 15, 1954, a tax return for the short taxable year beginning January 1 and ending March 31, 1954. Thereafter, X shall make his annual returns and compute his net income on the basis of a fiscal year ending March 31.

Had X preferred, he could have changed to a fiscal year basis ending the last day of January, February, September, October, or November. However, if X had elected to change to a fiscal year accounting period ending on the last day of April, May, June, July, or August the prior approval of the Commissioner would be required since such a change would result in a return for a short taxable year ending more than 3 months and less than 9 months after the close of the accounting period regularly used by X.

(4) *Approval of change of accounting period.* Where prior approval of a change of accounting period is required, application shall be filed on Form 1128 with the Commissioner of Internal Revenue, Washington, D. C., on or before the 15th day following the close of the short taxable year for which a return would be required to effect the change of accounting period. In general, an application for a change of accounting period will be approved where the taxpayer establishes valid business reasons for making such change. A change of accounting period intended to be made primarily for the purpose of effecting a tax saving shall not be allowed except where such tax saving results from the application of section 12 (d) the so-called "income splitting" provision, in the case where a husband and wife adopt the same accounting period in order to file a joint return and no other reason appears which is considered sufficient by the Commissioner for denying such permission.

(5) *Change of accounting period by a subsidiary corporation filing a consolidated return.* The foregoing provisions of this paragraph have no application in the case of a subsidiary corporation required to change its accounting period because it has elected to file consolidated returns. See § 24.14 of this chapter (Regulations 129) In such a case, if a change of accounting period is made on or after July 1, 1953, the corporation shall complete Form 1128 and forward it to the district director of internal revenue with whom the consolidated return is to be filed at or before the time of filing of such consolidated return.

§ 39.47 *Statutory provisions; accounting periods and methods of accounting;*

returns for periods of less than 12 months.

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*—(1) *General rule.* If a separate return is made 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 (referred to in this subsection as "the short period"), shall be placed on an annual basis by multiplying the amount thereof by twelve, and dividing by the number of months in the short period. The tax shall be such part of the tax computed on such annual basis as the number of months in the short period is of twelve months.

(2) *Exception.* If the taxpayer establishes the amount of his net income for the period of twelve months beginning with the first day of the short period, computed as if such twelve-month period were a taxable year, under the law applicable to such year, then the tax for the short period shall be reduced to an amount which is such part of the tax computed on the net income for such twelve-month period as the net income computed on the basis of the short period is of the net income for the twelve-month period. The taxpayer (other than a taxpayer to which the next sentence applies) shall compute the tax and file his return without the application of this paragraph. If the taxpayer (other than a corporation) was not in existence at the end of the twelve-month period, or if the taxpayer is a corporation and has disposed of substantially all its assets prior to the end of such twelve-month period, then in lieu of the net income for such twelve-month period there shall be used for the purposes of this paragraph the net income for the twelve-month period ending with the last day of the short period. The tax computed under this paragraph shall in no case be less than the tax computed on the net income for the short period without placing such net income on an annual basis. The benefits of this paragraph shall not be allowed unless the taxpayer, at such time as regulations prescribed hereunder require (but not after the time prescribed for the filing of the return for the first taxable year which ends on or after twelve months after the beginning of the short period), makes application therefor in accordance with such regulations. Such application, in case the return was filed without regard to this paragraph, shall be considered a claim for credit or refund with respect to the amount by which the tax is reduced under this paragraph. The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary for the application of this paragraph.

(d) *Earned income.* [Repealed by sec. 107 (a), Rev. Act 1943.]

(e) *Reduction of credits against net income.* In the case of a return made for a fractional part of a year under section 146 (a) (1), the exemptions provided in section 25 (b) shall be reduced to amounts which bear the same ratio to the full exemptions so 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.

(g) *Returns where taxpayer not in existence for twelve months.* In the case of a taxpayer not in existence during the whole of an annual accounting period ending on the last day of a month, or, if the taxpayer has no such annual accounting period or does not keep books, during the whole of a calendar year, the return shall be made for the fractional part of the year during which the taxpayer was in existence.

[Sec. 47 as amended by sec. 135 (a), (c), Rev. Act 1942; secs. 104, 107 (a), Rev. Act 1943; sec. 10 (c), Individual Income Tax Act 1944; sec. 102 (b) (3), Rev. Act 1945]

§ 39.47–1 *Returns for periods of less than 12 months.* (a) 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 whenever 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, except as otherwise provided in §§ 39.53–1, 39.56–1, 39.217–1, 39.218–1, 39.235–1, and 39.236–1. If a return is made for a fractional part of a year resulting from the termination of the taxable period by the Commissioner under section 146, the exemptions for normal tax and surtax shall be reduced to that proportion of the full exemptions for normal tax and surtax which the number of months in the period for which the return is made bears to 12 months, but such exemptions shall not be reduced for a fractional part of a year otherwise resulting. A return is required in the case of every taxable year which is a period of less than 12 months, if the gross income for such taxable year is greater than one exemption for normal tax and surtax as so reduced.

(b) The return of a decedent for the taxable year in which falls the date of his death is a return for the period during which he was alive.

(c) Any reference in the regulations in this part to a taxable year which is the calendar year (see, for example, the regulations under sections 11–15, inclusive, and 108) means a taxable year of 12 months beginning on January 1 and ending on December 31. The term does not include a taxable year of less than 12 months, even though the taxpayer may have customarily made his returns on the basis of a calendar year.

§ 39.47–2 *Returns for period of less than 12 months on account of a change in accounting period*—(a) *Net income placed on annual basis and tax computed thereon.* (1) In the case of a return for a period of less than 12 months on account of a change in accounting period, section 47 (c) provides that the net income computed on the return for such short period shall be placed on an annual basis by multiplying the amount thereof by 12 and dividing by the number of months in the short period. The tax is such part of the tax computed on such annual basis as the number of months in the period is of 12 months.

(2) In placing on an annual basis the net income of a corporation for a short period, the credit for dividends received is placed on an annual basis to correspond to the amount of dividends received included in the net income, which amount is placed on an annual basis when such net income is placed on an annual basis. Similarly, the credit for interest on United States obligations should reflect the amount of such interest as increased when such amount is placed on an annual basis as part of the net income which is placed on an annual basis.

(3) The following examples illustrate the application of this paragraph:

Example (1). A citizen of the United States made a return for the 10-month period ended October 31, 1952, on account of a change in accounting period. His net income for such 10-month period was $10,000. He was entitled to exemptions for normal tax and surtax of $1,200. His tax for the period is $2,743.33, 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
Less: Exemption for normal tax and surtax	1,200.00
Net income subject to normal tax and surtax	10,800.00
Normal tax (3 percent of $10,800)	324.00
Surtax on $10,800	2,968.00
Total tax on annual basis	3,292.00
Amount of tax for 10-month period $\left(\$3{,}292.00 \times \frac{10}{12}\right)$	2,743.33

Example (2). The X Corporation made a return for the 8-month period ended August 31, 1952, on account of a change in accounting period. The net income of the corporation for such 8-month period was $72,000, including $4,000 interest on obligations of the United States described in section 26 (a) and $12,000 in dividends from a domestic corporation, for which the credit provided in section 26 (b) is applicable. The normal tax and surtax for the 8-month period is $27,269.33, computed as follows:

Net income for 8-month period		$72,000.00
Multiplied by 12		864,000.00
Net income on annual basis ($864,000—8)		108,000.00
Dividends received, subject to the credit provided in section 26 (b)	$12,000.00	

Multiplied by 12	$144,000.00	
Dividends received placed on annual basis ($144,000 ÷ 8)	18,000.00	
Subtracting: Credit provided in section 26 (b) for dividends received (85 percent of $18,000)		$15,300.00
Surtax net income		92,700.00
Interest on United States obligations subject to credit provided in section 26 (a)	$4,000.00	
Multiplied by 12	48,000.00	
Subtracting: Credit provided in section 26 (a) for interest placed on annual basis ($48,000 ÷ 8)		6,000.00
Normal tax net income		86,700.00
Normal tax on $86,700.00		26,010.00
Surtax on $92,700.00		14,894.00
Total tax on annual basis		40,904.00
Amount of tax for period $\left(\$40{,}904 \times \frac{8}{12}\right)$		27,269.33

(b) *Tax for short period determined by annual income.* (1) If the taxpayer applies to the Commissioner in the manner provided in paragraph (c) of this section to have his tax computed under the provisions of section 47 (c) (2) and if the taxpayer establishes the amount of his net income for the 12-month period hereinafter described, then section 47 (c) (2) provides that the tax for the short period shall be reduced to an amount which is such part of the tax computed on the basis of the net income which the taxpayer has established for the 12-month period as the net income for the short period is of the net income for the 12-month period. If such amount, however, is greater than the tax computed under paragraph (a) of this section, the tax for the short period is the tax computed under paragraph (a) of this section. The 12-month period referred to above is the 12-month period beginning with the first day of the short period, except that if the taxpayer (other than a corporation) is not in existence at the end of such 12-month period, or if the taxpayer is a corporation which has distributed substantially all its assets prior to the end of such 12-month period, then it is the 12-month period ending with the last day of the short period. If a corporation ceases business and distributes so much of the assets used in its business that it cannot resume its customary operations with the remaining assets, it will be considered to have distributed substantially all of its assets.

(2) In computing the tax under section 47 (c) (2) the net income for the short period is not placed on an annual basis. The net income for the 12-month period is computed under the same provisions of law as are applicable to the short period, and is computed as if the 12-month period were an actual accounting period of the taxpayer. All items which fall in such 12-month period must be included even if they are extraordinary in amount or of an unusual nature. If the taxpayer is a member of a partnership, there shall be included in computing his income for the 12-month period his share of the partnership income for taxable years of the partnership ending with or during such 12-month period, but no amount shall be included with respect to a taxable year of the partnership ending after such 12-month period.

(3) If any other item partially applicable to such 12-month period can be determined only at the end of a taxable year which includes only part of the 12-month period, the taxpayer, subject to review by the Commissioner, shall apportion such item to the 12-month period in such manner as will most clearly reflect the income for the 12-month period. In the case of a taxpayer permitted or required to take inventories, the cost of goods sold during the part of the 12-month period included in the taxable year shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for the part of the 12-month period included in the taxable year is of the gross receipts from sales for the entire taxable year. For example, the 12-month period of a corporation, engaged in the sale of merchandise, which has a short period from January 1, 1952, to September 30, 1952, is the calendar year 1952. The 3-month period October 1, 1952, to December 31, 1952, is a part of the fiscal year ending September 30, 1953. The cost of goods sold during such 3-month period is such part of the cost of goods sold during the entire fiscal year ending September 30, 1953, as the gross receipts from sales for such 3-month period are of the gross receipts from sales for the entire fiscal year. The Commissioner may, in granting permission to a taxpayer to change its accounting period, require as a condition to granting the change that, if the taxpayer is to obtain the benefits of section 47 (c) (2), it shall take a closing inventory upon the last day of the 12-month period. Such closing inventory will be used only for the purposes of section 47 (c) (2), and the taxpayer will not be required to use such inventory in computing the net income for the taxable year in which such inventory is taken.

(4) The tax for the short period may not be reduced under section 47 (c) (2) to an amount which is less than the tax for the short period computed on the basis of the net income for the short period without placing such net income on an annual basis. If the tax computed under section 47 (c) (2) by reference to the net income for a 12-month period is less than such amount, the tax may be reduced only to such amount.

(5) The following examples illustrate the application of section 47 (c) (2)

Example (1). The facts are the same as in example (1) in paragraph (a) (3) of this section. In the period from November 1, 1952, to December 31, 1952, the taxpayer has $1,000 net income. His net income for the 12-month period from January 1, 1952, to December 31, 1952, is, therefore, $11,000. The taxpayer files an application under paragraph (c) of this section for a reduction of his tax to an amount computed on the basis of his actual net income for the 12-month period from January 1, 1952, to December 31, 1952. His tax is reduced to $2,618.18, computed as follows:

Net income for 12-month period		$11,000.00
Less: Exemptions for normal tax and surtax		1,200.00
Income subject to normal tax		9,800.00
Normal tax (3 percent of $9,800)		294.00
Surtax on $9,800		2,586.00
Total tax on annual income		2,880.00
Net income for 10-month period	$10,000.00	
Net income for 12-month period	$11,000.00	
Amount of tax for 10-month period $\left(\frac{10{,}000}{11{,}000} \times \$2{,}880.00\right)$		2,618.18

The amount of tax which would be due if the income were not placed on an annual basis is $2,500.00, computed as follows:

Net income for 10-month period	$10,000.00
Less: Exemptions for normal tax and surtax	1,200.00
Net income subject to normal tax and surtax	8,800.00
Normal tax (3 percent of $8,800)	264.00
Surtax on $8,800	2,236.00
Total tax for 10-month period	2,500.00

Since the tax for the short period computed under section 47 (c) (2) by reference to the actual income for the 12-month period, or $2,618.18, is greater than the tax which would be due if the income for the short period were not placed on an annual basis, or $2,500.00, the tax for the short period is reduced to $2,618.18, the tax computed by reference to the income for the 12-month period.

Example (2). The facts are the same as in example (1) of this subparagraph, except that during the period from November 1, 1952, to December 31, 1952, the taxpayer has no income, but has deductible business expenses of $1,000. His net income for the 12-month period from January 1, 1952, to December 31, 1952, is, therefore, $9,000. The taxpayer filed an application under paragraph (c) of this section for a reduction of his tax under the provisions of section 47 (c) (2). The tax computed on the basis of the net income for the period from January 1, 1952, to October 31, 1952, without placing such net income on an annual basis is $2,500.00 (see example (1)). The tax computed under section 47 (c) (2) by reference to the actual net income for the 12-month period from January 1, 1952, to December 31, 1952, is $2,364.44, computed as follows:

Net income for 12-month period		$9,000.00
Less: Exemptions for normal tax and surtax		1,200.00
Net income subject to normal tax and surtax		7,800.00
Normal tax (3 percent of $7,800)		234.00
Surtax on $7,800		1,834.00
Total tax on annual income		2,128.00
Net income for 10-month period	$10,000.00	
Net income for 12-month period	9,000.00	
Amount of tax for 10-month period $\left(\frac{10{,}000}{9{,}000} \times \$2{,}128.00\right)$		2,364.44

Since the tax computed on the basis of the net income for the short period without placing such net income on an annual basis, or $2,500.00, is greater than $2,364.44, the tax

computed by reference to the actual net income for the 12-month period, the tax for the short period under section 47 (c) (2) is $2,500.00.

Example (3). The facts are the same as in example (2) in paragraph (a) (3) of this section. The taxpayer applies to have its tax reduced under the provisions of section 47 (c) (2). During the 4-month period from September 1, 1952, to December 31, 1952, the X Corporation has $16,000 net income, including $3,000 dividends from a domestic corporation for which the credit provided in section 26 (b) is applicable and $1,000 interest on obligations of the United States described in section 26 (a). The net income for the 12-month period from January 1, 1952, to December 31, 1952, is, therefore, $88,000. For such 12-month period, the dividends from domestic corporations for which the credit provided in section 26 (b) is applicable amount to $15,000, and the interest on United States obligations described in section 26 (a) amounts to $5,000. The normal tax and surtax for the short period is reduced under section 47 (c) (2) to $26,288.18, computed as follows:

Net income for 12-month period Jan. 1, 1952, to Dec. 31, 1952		$88,000.00
Subtracting: Dividends received credit provided by section 26 (b) (85 percent of $15,000)		12,750.00
Surtax net income		75,250.00
Less: Credit provided in section 26 (a) for interest on United States obligations		5,000.00
Normal tax net income		70,250.00
Normal tax on $70,250.00		21,075.00
Surtax on $75,250.00		11,055.00
Total tax on annual income		32,130.00
Net income for 8-month period Jan. 1, 1952, to Aug. 31, 1952	$72,000	
Net income for 12-month period Jan. 1, 1952, to Dec. 31, 1952	88,000	
Amount of tax for 8-month period Jan. 1, 1952, to Aug. 31, 1952 $\left(\frac{72,000}{88,000}\times \$32,130.00\right)$		26,288.18

The amount of normal tax and surtax that would be due if the income for the short period were not placed on an annual basis is $25,436.00, computed as follows:

Net income for 8-month period	$72,000.00
Credit for dividends received (85 percent of $12,000)	10,200.00
Surtax net income	61,800.00
Less: Credit for interest on United States obligations	4,000.00
Normal tax net income	57,800.00
Normal tax on $57,800.00	17,340.00
Surtax on $61,800	8,096.00
Total tax for period	25,436.00

Since the tax for the short period computed under section 47 (c) (2) by reference to the actual income for the 12-month period, or $26,288.18, is greater than the tax that would be due if the income for the short period were not placed on an annual basis, or $25,436.00, the tax for the short period is reduced to $26,288.18, the tax computed by reference to the income for the 12-month period.

(c) *Application to compute tax under section 47 (c) (2)* A taxpayer desiring the benefit of section 47 (c) (2) must file an application therefor. If at the time the return for the short period is filed the taxpayer is able to determine that the 12-month period ending with the close of the short period will be used in the computations under section 47 (c) (2) then the tax on the return for the short period may be determined under the provisions of section 47 (c) (2) In such a case, an income tax return form covering the 12-month period shall be attached to the return as a part thereof, and the return will then be considered the application for the benefits of section 47 (c) (2) required by that section. In all other cases, the taxpayer shall file its return and compute its tax as provided in paragraph (a) of this section, and the application for the benefits of section 47 (c) (2) shall be made in the form of a claim for credit or refund. The claim shall set forth the computation of the net income and the tax thereon for the 12-month period, and must be filed not later than the time prescribed for filing the return for the first taxable year ending with or after the twelfth month after the beginning of the short period. For example, the taxpayer changes its accounting period from the calendar year basis to the fiscal year basis ending September 30, and files a return for the period from January 1, 1952, to September 30, 1952. Its application for the benefits of section 47 (c) (2) must be filed not later than the time prescribed for filing its return for the first taxable year which ends on or after the last day of December 1952, the twelfth month after the beginning of the short period. In this case, the taxpayer must file its application not later than December 15, 1953, the time prescribed for filing the return for its fiscal year ending September 30, 1953. However, if it obtains an extension of time for filing the return for such fiscal year, it may file its application during the period of such extension. If the Commissioner determines that the taxpayer has established the amount of the net income for the 12-month period, any excess of the tax paid for the short period over the tax computed under section 47 (c) (2) will be credited or refunded to the taxpayer in the same manner as in the case of an overpayment.

§ 39.48 *Statutory provisions; accounting periods and methods of accounting; definitions.*

SEC. 48. *Definitions.* When used in this chapter—

(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" means, in the case of a return made for a fractional part of a year under the provisions of this chapter 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.

[Sec. 48 as amended by sec. 135 (d), Rev. Act 1942]

RETURNS AND PAYMENT OF TAX

§ 39.51 *Statutory provisions; returns and payment of tax; individual returns.*

SEC. 51. *Individual returns*—(a) *Requirement.* Every individual having for the taxable year a gross income of $600 or more shall make a return, which shall contain or be verified by a written declaration that it is made under the penalties of perjury. Such return shall set forth in such cases, and to such extent, and in such detail, as the Commissioner with the approval of the Secretary may by regulations prescribe, the items of gross income and the deductions and credits allowed under this chapter and such other information for the purpose of carrying out the provisions of this chapter as may be prescribed by such regulations.

(b) *Husband and wife*—(1) *In general.* A husband and wife may make a single return jointly. Such a return may be made even though one of the spouses has neither gross income nor deductions. If a joint return is made the tax shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several.

(2) *Nonresident alien.* No joint return may be made if either the husband or wife at any time during the taxable year is a nonresident alien.

(3) *Different taxable years.* No joint return shall be made if the husband and wife have different taxable years; except that if such taxable years begin on the same day and end on different days because of the death of either or of both, then the joint return may be made with respect to the taxable year of each. The above exception shall not apply if the surviving spouse remarries before the close of his taxable year, nor if the taxable year of either spouse is a fractional part of a year under section 47 (a).

(4) *Joint return after death.* In the case of the death of one spouse or both spouses the joint return with respect to the decedent may be made only by his executor or administrator; except that in the case of the death of one spouse the joint return may be made by the surviving spouse with respect to both himself and the decedent if (A) no return for the taxable year has been made by the decedent, (B) no executor or administrator has been appointed, and (C) no executor or administrator is appointed before the last day prescribed by law for filing the return of the surviving spouse. If an executor or administrator of the decedent is appointed after the making of the joint return by the surviving spouse, the executor or administrator may disaffirm such joint return by making, within one year after the last day prescribed by law for filing the return of the surviving spouse, a separate return for the taxable year of the decedent with respect to which the joint return was made, in which case the return made by the survivor shall constitute his separate return.

(5) *Determination of status.* For the purposes of this section—

(A) The status as husband and wife of two individuals having taxable years beginning on the same day shall be determined—

(i) If both have the same taxable year—as of the close of such year; and

(ii) If one dies before the close of the taxable year of the other—as of the time of such death; and

(B) An individual who is legally separated from his spouse under a decree of divorce

or of separate maintenance shall not be considered as married.

(6) *Tax in case of joint return.* For determination of combined normal tax and surtax under section 11 and section 12 (b) in case of joint return under this subsection, see section 12 (d). For tax in case of joint return of husband and wife electing to pay the tax under Supplement T, see section 400.

(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.* [Repealed by sec. 4 (b), Pub. Law 271 (81st Cong.)].

(e) *Fiduciaries.* For returns to be made by fiduciaries, see section 142.

(f) *Tax computed by collector in case of wage earners*—(1) *Return requirements.* An individual entitled to elect to pay the tax imposed by Supplement T whose gross income is less than $5,000 and is entirely from one or more of the following sources: Remuneration for services performed by him as an employee, dividends, or interest; and whose gross income from sources other than wages, as defined in section 1621 (a), does not exceed $100, shall at his election be relieved, by using the form prescribed as the form for the return for the purposes of this subsection, from showing on the return the tax imposed by this chapter. In such case the tax shall be computed by the collector. In the case of a head of a household electing the benefits of this subsection, the tax shall be computed by the collector under Supplement T without regard to the taxpayer's status as head of a household.

(2) *Result of computation.* After the collector has computed the tax, he shall mail to the taxpayer a notice stating the amount determined by the collector as payable and making demand therefor.

(3) *Regulations.* The Commissioner with the approval of the Secretary shall prescribe regulations for carrying out this subsection, and such regulations may provide for the application of the rules of this subsection to cases where the gross income includes items other than those enumerated in paragraph (1), to cases where the gross income from sources other than wages on which the tax has been withheld at the source is more than $100 but not more than $200, and to cases where the gross income is $5,000 or more but not more than $5,200. Such regulations shall provide (A) for the application of this subsection in the case of husband and wife, including provisions determining when a joint return under this subsection may be permitted or required and what constitutes a joint return, whether the liability shall be joint and several, and whether one spouse may make return under this subsection and the other without regard to this subsection, and (B) whether and the extent to which the benefits of this subsection may be availed of, in the case of taxable years beginning in the calendar year 1944, by persons required to make or making payments of estimated tax with respect to any such taxable year.

(4) *Method of election.* The election to have the benefits of this subsection shall be made by making return on the form prescribed as the form for the return for the purposes of this subsection. An election so made shall constitute an election to pay the tax imposed by Supplement T.

(g) *Joint return after filing separate return*—(1) *In general.* If an individual has filed a separate return for a taxable year for which a joint return could have been made by him and his spouse under subsection (b) of this section, and the time prescribed by law for filing the return for such taxable year has expired, such individual and his spouse may nevertheless make a joint return for such taxable year. A joint return filed by the husband and wife in such a case shall constitute the return of the husband and wife for such taxable year, and all payments, credits, refunds, or other repayments made or allowed with respect to the separate return of either spouse for such taxable year shall be taken into account in determining the extent to which the tax based upon the joint return has been paid.

(2) *Payments required before joint return can be made.* A joint return can be made under paragraph (1) only if there is paid in full at or before the time of the filing of the joint return—

(A) All amounts previously assessed with respect to either spouse for such taxable year;

(B) All amounts shown as the tax by either spouse upon his separate return for such taxable year; and

(C) Any amount determined, at the time of the filing of the joint return, as a deficiency with respect to either spouse for such taxable year if, prior to such filing, a notice under section 272 (a) of such deficiency has been mailed.

(3) *Time for making joint return.* A joint return cannot be made under paragraph (1)—

(A) After the expiration of three years from the last date prescribed by law for filing the return for such taxable year (determined without regard to any extension of time granted to either spouse);

(B) After there has been mailed to either spouse, with respect to such taxable year, a notice of deficiency under section 272 (a), if the spouse, as to such notice, files a petition with the Tax Court of the United States within the time prescribed in such section;

(C) After either spouse has commenced a suit in any court for the recovery of any part of the tax for such taxable year; or

(D) After either spouse has entered into a closing agreement under section 3760 with respect to such taxable year, or after any civil or criminal case arising against either spouse with respect to such taxable year has been compromised under section 3761.

(4) *Elections made in separate return.* If a joint return is made under this subsection, any election (other than the election to file a separate return) made by either spouse in his separate return for such taxable year with respect to the treatment of any income, deduction, or credit of such spouse shall not be changed in the making of the joint return where such election would have been irrevocable if the joint return had not been made.

(5) *Death of spouse.* If a joint return is made under this subsection after the death of either spouse, such return with respect to the decedent can be made only by his executor or administrator.

(6) *Additions to the tax.* Where the amount shown as the tax by the husband and wife on a joint return made under this subsection exceeds the aggregate of the amounts shown as the tax upon the separate return of each spouse—

(A) *Negligence.* If any part of such excess is attributable to negligence or intentional disregard of rules and regulations (but without intent to defraud) at the time of the making of such separate return, then 5 per centum of the total amount of such excess shall be assessed, collected, and paid in the same manner as if it were a deficiency;

(B) *Fraud.* If any part of such excess is attributable to fraud with intent to evade tax at the time of the making of such separate return, then 50 per centum of the total amount of such excess shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612 (d) (2).

(7) *Rules for application of sections 275 and 291.* For the purposes of section 275 (relating to period of limitations upon assessment and collection), and for the purposes of section 291 (relating to delinquent returns), a joint return made under this subsection shall be deemed to have been filed—

(A) Where both spouses filed separate returns prior to making the joint return—on the date the last separate return was filed (but not earlier than the last date prescribed by law for filing the return of either spouse);

(B) Where only one spouse filed a separate return prior to the making of the joint return, and the other spouse had less than $600 of gross income for such taxable year—on the date of the filing of such separate return (but not earlier than the last date prescribed by law for the filing of such separate return); or

(C) Where only one spouse filed a separate return prior to the making of the joint return, and the other spouse had gross income of $600 or more for such taxable year—on the date of the filing of such joint return.

(8) *Rule for application of section 322.* For the purposes of section 322 (relating to refunds and credits), a joint return made under this subsection shall be deemed to have been filed on the last date prescribed by law for filing the return for such taxable year (determined without regard to any extension of time granted to either spouse).

(9) *Additional time for assessment.* If a joint return is made under this subsection, the period of limitations provided in sections 275 and 276 on the making of assessments and the beginning of distraint or a proceeding in court for collection shall with respect to such return include one year immediately after the date of the filing of such joint return (computed without regard to the provisions of paragraph (7) of this subsection).

(10) *Rule for application of section 3809 (a).* For the purposes of section 3809 (a) (relating to criminal penalties in the case of fraudulent returns) the term "return" includes a separate return filed by a spouse with respect to a taxable year for which a joint return is made under this subsection after the filing of such separate return.

[Sec. 51 as amended by sec. 7 (a), Rev. Act 1940; sec. 112 (a), Rev. Act 1941; secs. 131 (c) (1), 136 (a), Rev. Act 1942; sec. 105, Rev. Act 1943; sec. 11 (a), (b) Individual Income Tax Act 1944; secs. 202 (c) (1), 303, Rev. Act 1948; sec. 4 (b), Pub. Law 271 (81st Cong.); secs. 301 (b), 312 (a), Rev. Act 1951]

§ 39.51-1 *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, by every individual residing within the United States though not a citizen thereof, and by every alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, regardless of family or marital status, if such citizen or resident has for such taxable year a gross income of $600 or more, or a gross income in excess of the credit allowed by section 25 (b) prorated as provided in section 47 (e)

(b) *Joint returns*—(1) *In general.* (i) A husband and wife occupying the marital status as of the last day of the taxable year may elect to make a joint return (see section 51 (b)) even though one of the spouses has no gross income or deductions, and even though the spouses are not living together at any time during the taxable year. However, for the purpose of filing a joint return, an individual legally separated from his spouse under a decree of separate maintenance shall not be considered as married.

(ii) For any taxable year where a joint return has been filed, separate returns may not be made by the spouses after the time for filing the return of either has expired. See, however, subparagraph (2) (v) of this paragraph for the right of an executor to file a late separate return for a deceased spouse and thereby disaffirm a timely joint return made by the surviving spouse.

(iii) If a joint return is made, the gross income and adjusted gross income of husband and wife on the joint return are computed in an aggregate amount and the deductions allowed and the net income are likewise computed on an aggregate basis. Deductions limited to a percentage of the adjusted gross income, such as the deduction for charitable contributions under section 23 (o) will be allowed with reference to such aggregate adjusted gross income. Similarly, in the case of a joint return, losses of husband and wife from sales or exchanges of capital assets are combined and such combined losses are allowed under section 117 (d) (2) only to the extent of the combined gains of the spouses from such sales or exchanges, plus the net income (or adjusted gross income if the tax is computed under Supplement T) or $1,000 whichever is smaller. The "net income" referred to in section 117 (d) (2) is the net income computed before reduction by one-half for the purposes of income splitting under section 12 (d) and is such net income computed without regard to gains and losses from sales or exchanges of capital assets. Although there are two taxpayers on a joint return, there is only one net income. The tax on the joint return shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several. A joint return may not be made if either the husband or wife at any time during the taxable year is a nonresident alien. For computation of tax on the basis of the splitting of income in the case of a joint return, see § 39.12—3. For tax in the case of a joint return of husband and wife electing to pay the tax under Supplement T, see §§ 39.400–1 and 39.401–1.

(2) *Joint return after death.* (i) Since in general a joint return may not be made if husband and wife have different taxable years, and since the taxable year of an individual closes as of the date of his death (see § 39.47–1) no joint return may be made for any taxable year, except as provided by section 51 (b) or by section 51 (g) in the case of the death of one or both spouses prior to the last day of such taxable year. Section 51 (b) provides that a joint return may be made for the survivor and the deceased spouse or for both deceased spouses if the taxable years of such spouses begin on the same day and end on different days only because of the death of either or both. Thus, if a husband and wife make their returns on a calendar year basis, and the wife dies on August 1, 1952, a joint return may be made with respect to the calendar year 1952 of the husband and the taxable year of the wife beginning on January 1, 1952, and ending with her death on August 1, 1952. Similarly if husband and wife both make their returns on the basis of a fiscal year beginning on July 1 and the wife dies on October 1, 1952, a joint return may be made with respect to the fiscal year of the husband beginning on July 1, 1952, and ending on June 30, 1953, and with respect to the taxable year of the wife beginning on July 1, 1952, and ending with her death on October 1, 1952. Section 51 (g) provides that a joint return may be made, under certain conditions, after separate rereturns have been filed even though the time prescribed by law for filing the return for such year has expired. See § 39.51–1 (b) (3) A joint return made under section 51 (g) after the death of either spouse shall, with respect to the decedent, be made only by his executor or administrator. Thus, where no executor or administrator has been appointed, a joint return cannot be made under section 51 (g) For the purposes of this subparagraph the status of two individuals as husband and wife, if one dies prior to the close of the taxable year of the other, shall be determined as of the time of such death.

(ii) The provision allowing a joint return to be made for the taxable year in which the death of either or both spouses occurs is subject to two exceptions. The first exception is that if the surviving spouse remarries before the close of his taxable year, he may not make a joint return with the first spouse who died during the taxable year. In such a case, however, the surviving spouse may make a joint return with his new spouse provided that the other requirements of section 51 (b) are met. The second exception is that the surviving spouse may not make a joint return with the deceased spouse if the taxable year of either spouse is a fractional part of a year under section 47 (a) resulting from a change of accounting period. For example, if a husband and wife make their returns on the calendar year basis and the wife dies on March 1, 1952, and thereafter the husband receives permission to change his accounting period to a fiscal year beginning July 1, 1952, no joint return may be made for the short taxable year ending June 30, 1952. Similarly, if a husband and wife who make their returns on a calendar year basis receive permission to change to a fiscal year beginning July 1, 1952, and the wife dies on June 1, 1952, no joint return may be made for the short taxable year ending June 30, 1952.

(iii) Section 51 (b) (4) provides for the method of making a joint return in the case of the death of one spouse or both spouses. The general rule is that, in the case of the death of one spouse, or of both spouses, the joint return with respect to the decedent may be made only by his executor or administrator. By the term executor or administrator is meant the person who is actually appointed to such office and not merely a person who may be in charge of the property of the decedent. An exception is made from this general rule whereby, in the case of the death of one spouse, the joint return may be made by the surviving spouse with respect to both him and the decedent if all the following conditions exist:

(*a*) No return has been made by the decedent for the taxable year in respect to which the joint return is made.

(*b*) No executor or administrator has been appointed at or before the time of making such joint return.

(*c*) No executor or administrator is appointed before the last day prescribed by law for filing the return of the surviving spouse.

These conditions are to be applied with respect to the return for each of the taxable years of the decedent for which a joint return may be made if more than one such taxable year is involved. Thus, in the case of husband and wife on the calendar year basis, if the wife dies in February 1953, a joint return for the husband and wife for 1952 may be made if the conditions set forth above are satisfied with respect to such return. A joint return may also be made by the survivor for both himself and the deceased spouse for the calendar year 1953 if it is separately determined that the conditions set forth above are satisfied with respect to the return for such year. If, however, the deceased spouse should, prior to her death, make a return for 1952, the surviving spouse may not thereafter make a joint return for himself and the deceased spouse for 1952.

(iv) If an executor or administrator is appointed at or before the time of making the joint return or before the last day prescribed by law for filing the return of the surviving spouse, the surviving spouse cannot make a joint return for himself and the deceased spouse whether or not a separate return for the deceased spouse is made by such executor or administrator. In such a case, any return made solely by the surviving spouse shall be treated as his separate return. The joint return, if one is to be made, must be made by both the surviving spouse and the executor or administrator. In determining whether an executor or administrator is appointed before the last day prescribed by law for filing the return of the surviving spouse, an extension of time for making the return is included.

(v) If the surviving spouse makes the joint return provided for in subdivision (iii) and thereafter an executor or administrator of the decedent is appointed, the executor or administrator may disaffirm such joint return. This disaffirmance, in order to be effective, must be made within one year after the last day prescribed by law for filing the return of the surviving spouse (including any extension of time for filing such return) and must be made in the form of a separate return for the taxable year of the decedent with respect to which the joint return was made. In the event of such proper disaffirmance the return made by the survivor shall constitute his separate return, that is, the joint return made by him shall be treated as his return and the tax thereon shall be computed by excluding all items properly includible in the return of the deceased spouse. The separate return made by the execu-

tor or administrator shall constitute the return of the deceased spouse for the taxable year.

(vi) The time allowed the executor or administrator to disaffirm the joint return by the making of a separate return does not establish a new due date for the return of the deceased spouse. Accordingly, the provisions of sections 291 and 294, relating to delinquent returns and delinquency in payment of tax, are applicable to such return made by the executor in disaffirmance of the joint return.

(3) *Joint return after filing separate return*—(i) *In general.* (*a*) Where an individual has filed a separate return for a taxable year for which a joint return could have been made by him and his spouse under section 51 (b) and the time prescribed by law for filing the return for such taxable year has expired, such individual and his spouse may, under conditions hereinafter set forth, make a joint return for such taxable year. The joint return filed pursuant to section 51 (g) shall constitute the return of the husband and wife for such year, and all payments, credits, refunds, or other repayments, made or allowed with respect to the separate return of either spouse are to be taken into account in determining the extent to which the tax based on the joint return has been paid.

(*b*) For the purpose of this section, the determination whether an individual is married at any time during the taxable year shall be made in accordance with the provisions of section 51 (b) (5) See § 39.51-1 (b) (1) The fact that the taxpayer and his spouse are divorced or legally separated at any time after the close of the taxable year for which separate returns are filed shall not deprive them of their right to file a joint return for such taxable year pursuant to section 51 (g)

(ii) *Payments required before joint returns can be made.* A joint return may not be made under section 51 (g) for a taxable year unless at or before the time of the filing of such joint return the following amounts are paid:

(*a*) All amounts previously assessed with respect to either spouse for such taxable year;

(*b*) All amounts shown as the tax by either spouse upon his separate return for such taxable year; and

(*c*) Any amount determined, at the time of the filing of the joint return, as a deficiency with respect to either spouse for such taxable year if, prior to such filing, a notice under section 272 (a) of such deficiency has been mailed.

(iii) *Time for making joint return.* A joint return may not be made under section 51 (g) with respect to a taxable year:

(*a*) After the expiration of 3 years from the last day prescribed by law for filing the return for such taxable year determined without regard to any extension of time granted to either spouse. Thus where an extension of time for filing returns has been granted by the Commissioner or his representative in accordance with section 53 (a) the extension shall be disregarded in determining the last day upon which a joint return may be filed after separate returns have been filed.

(*b*) After there has been mailed to either spouse, with respect to such taxable year, a notice of deficiency under section 272 (a) if the spouse, as to such notice, files a petition with the Tax Court of the United States within the time prescribed in section 272 (a) that is, within 90 days (or 150 days if notice is addressed to taxpayer outside the States of the Union and the District of Columbia) after the mailing of the notice, excluding Saturday, Sunday, or a legal holiday in the District of Columbia as the ninetieth day;

(*c*) After either spouse has commenced a suit in any court for the recovery of any part of the tax for such taxable year; or

(*d*) After either spouse has entered into a closing agreement under section 3760 with respect to such taxable year, or after any civil or criminal case arising against either spouse with respect to such taxable year has been compromised under section 3761.

(iv) *Elections made in separate return.* If a joint return is made under section 51 (g), any election, other than the election to file a separate return, made by either spouse in his separate return for the taxable year with respect to the treatment of any income, deduction, or credit of such spouse shall not be changed in the making of the joint return where such election would have been irrevocable if the joint return had not been made. Thus, if one spouse has made an irrevocable election to adopt and use the last-in, first-out inventory method under section 22 (d) this election may not be changed upon making the joint return under section 51 (g).

(v) *Additions to the tax.* Where the amount shown as the tax by the husband and wife on a joint return made under section 51 (g) exceeds the aggregate of the amounts shown as tax on the separate return of each spouse, and such excess is attributable to negligence, intentional disregard of rules and regulations, or fraud at the time of the making of such separate returns, there shall be assessed, collected, and paid in the same manner as if it were a deficiency an additional amount as provided in the two succeeding sentences. If any part of such excess is attributable to negligence, or intentional disregard of rules and regulations, at the time of the making of such separate return, but without any intent to defraud, this additional amount shall be 5 percent of the total amount of the excess. If any part of such excess is attributable to fraud with intent to evade tax at the time of the making of such separate return, this additional amount shall be 50 percent of the total amount of the excess. The latter addition is in lieu of the 50 percent addition to the tax provided in section 3612 (d) (2)

(vi) *Rules for application of sections 275 and 291.* For the purpose of section 275, relating to the period of limitations upon assessment and collection, and section 291, relating to delinquent returns, a joint return made under section 51 (g) shall be deemed to have been filed, giving due regard to any extension of time granted to either spouse, on the following dates:

(*a*) Where both spouses filed separate returns, prior to making the joint return under section 51 (g) on the date the last separate return of either spouse was filed for the taxable year, but not earlier than the last date prescribed by law for the filing of the return of either spouse;

(*b*) Where only one spouse was required and did file a return prior to the making of the joint return under section 51 (g) on the date of the filing of the separate return, but not earlier than the last day prescribed by law for the filing of such return; and

(*c*) Where both spouses were required to file a return, but only one spouse did so file, on the date of the filing of the joint return under section 51 (g)

(vii) *Rule for application of section 322.* For the purpose of section 322, relating to refunds and credits, a joint return made under section 51 (g) shall be deemed to have been filed on the last date prescribed by law for filing the return for such taxable year, determined without regard to any extension of time granted to either spouse for filing the return or paying the tax.

(viii) *Additional time for assessment.* In the case of a joint return made under section 51 (g) the period of limitations provided in sections 275 and 276 shall not be less than 1 year after the date of the actual filing of such joint return. The expiration of the 1 year is to be determined without regard to the rules provided in subdivision (vi) of this subparagraph, relating to the application of sections 275 and 291 with respect to a joint return made under section 51 (g)

(ix) *Rule for application of section 3809 (a)* For the purposes of section 3809 (a), relating to criminal penalties in the case of a fraudulent return, the term "return" includes a separate return filed by a spouse for the taxable year for which a joint return is subsequently made under section 51 (g)

§ 39.51-2 *Form of return*—(a) *In general.* (1) The return shall be on Form 1040, except in the case of a taxpayer entitled to elect, and who so elects, to use the Form 1040A in accordance with the rules prescribed in paragraph (b) of this section. A taxpayer, even though entitled to use Form 1040A for the taxable year may, nevertheless, use Form 1040 as his return. Such taxpayer otherwise entitled to use Form 1040A as his return for the taxable year but who does not desire to take the standard deduction provided in section 23 (aa) is required to use Form 1040 as his return for such taxable year.

(2) The forms may be obtained from the district directors of internal revenue for the several internal revenue 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 before 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, except that an agent holding a valid and subsisting general power of attorney authorizing him to represent his principal in making, executing, and filing the income return, may submit a certified copy thereof in lieu of the authorization on 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 §§ 39.217-1 and 39.217-2.

(3) 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.

(b) *Use of optional return on Form 1040A.* (1) An individual entitled to elect to pay the tax imposed by Supplement T (except a taxpayer making his returns on a fiscal year basis) may elect to use Form 1040A as his return provided his gross income is less than $5,000, consists entirely of remuneration for personal services performed by him as an employee, dividends, or interest, and his gross income from sources other than wages, as defined in section 1621 (a) does not exceed $100. A taxpayer who makes his return on a basis other than the cash receipts and disbursements basis may not use Form 1040A as his return. A taxpayer who has made payments of estimated tax for a taxable year may not use Form 1040A as his return for such year. In the case of married persons domiciled in a community-property State, Form 1040A may not be used as a return by either spouse unless the aggregate gross income of husband and wife meets the tests prescribed above and they make a joint return. If they desire to file separate returns, Form 1040 must be used.

(2) An election to make a return on Form 1040A shall be exercised by properly executing and filing such form, to which shall be attached all Forms W-2 received for the taxable year, with the district director of internal revenue on or before the due date of the taxpayer's return. Such Form 1040A, when filled out and executed and having attached thereto all Forms W-2 received with respect to wages paid in the taxable year, shall, when timely filed, constitute such individual's return for such year if he is eligible under section 51 (f) to use the optional return.

(c) *Joint return of husband and wife on Form 1040A.* (1) If during the taxable year either husband or wife, or both, derive income from wages, as defined in section 1621 (a) and are furnished one or more Forms W-2, and the aggregate gross income of both spouses is less than $5,000, consists solely of remuneration for services performed as an employee, dividends, or interest, and includes a total of not more than $100 from dividends, interest, and remuneration for personal services other than such wages, the spouses may file a joint return on Form 1040A signed by both spouses, and all Forms W-2 received by both spouses for the taxable year shall be attached thereto.

(2) The tax computed by the district director of internal revenue upon the basis of a joint return on Form 1040A shall be the lesser of the following amounts:

(i) A tax computed as though the return on Form 1040A constituted the separate returns of the spouses, and

(ii) A tax computed as though the return on Form 1040A constituted a joint return.

(3) If a joint return is made by husband and wife on Form 1040A, the liability for the tax shall be joint and several.

(d) *Head of household.* In the case of a head of a household electing to make his return on Form 1040A in accordance with the rules prescribed in this section, the tax shall be computed under Supplement T without regard to the status of the taxpayer as the head of a household.

§ 39.51-3 *Return of income of minor.* An individual, although a minor, who is single, is required to render a return of income if he has gross income (including compensation for personal services includible in his gross income under section 22 (m) (1) of $600 or over for the taxable year regardless of the amount of his net income. If the aggregate of the gross 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 is at least $600, regardless of the amount of his net income, 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 § 39.142-2. If he is married, see § 39.51-1.

§ 39.51-4 *Verification of returns.* (a) A return of an individual required to be filed under section 51 shall contain or be verified by a written declaration that it is made under the penalties of perjury. All other income tax returns must be verified in the manner prescribed on the form for the return.

(b) Income tax returns actually prepared by other persons for individuals required to file returns under section 51 shall be verified as provided in section 51. If any person or persons actually prepare any other income return for another person, the prescribed form of verification on the return shall be executed by such person or persons preparing the return. Such verification is required on all such income returns required under the Internal Revenue Code except the following:

(1) Returns required under sections 143 and 144 (relating to withholding of tax at the source),

(2) Returns required to be made by departing aliens under section 146;

(3) Returns required under sections 147, 148, and 149 (relating to information at source),

(4) Returns by subsidiary corporations included in consolidated returns; and

(5) Returns required under sections 338 (a) 339, and 3604 (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 verification 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 verification is required. If the return is a separate return of a married person, the verification 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, an internal revenue agent, or other officer or employee of the Internal Revenue Service 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 verification required by this paragraph.

§ 39.51-5 *Use of prescribed forms.* Copies of the prescribed return forms will so far as possible be furnished taxpayers by district directors of internal revenue. 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 district director of internal revenue in ample time to have their returns prepared, verified, and filed with the district director of internal revenue 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 Internal Revenue Code. 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 §§ 39.53-2 to 39.53-4, inclusive.)

§ 39.52 *Statutory provisions; returns and payment of tax; corporation returns.*

SEC. 52. *Corporation returns*—(a) *Requirement.* Every corporation subject to taxation under this chapter shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this chapter and such other information for the purpose of carrying out the provisions of this chapter 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.

(b) *Cross reference.* For provisions relating to consolidated returns, see section 141. [Sec. 52 as amended by sec. 159 (f), Rev. Act 1942]

§ 39.52-1 *Corporation returns.* (a) 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. For returns of insurance companies, see §§ 39.201-1, 39.204-1, and 39.207-1, of foreign corporations, see section 235; and of affiliated corporations, see section 141 and § 39.141-1. For returns of certain corporations, otherwise exempt from tax under section 101 (1) (6) (7) or (14) which are subject to the tax imposed by section 421 (a) (1) upon their Supplement U net income, see § 39.421-3. For returns of certain governmental colleges or universities and corporations wholly owned by such colleges or universities, which are subject to the tax imposed by section 421 (a) (1) upon their Supplement U net income, see § 39.421-3.

(b) A corporation having an existence during any portion of a taxable year is required to make a return. If a corporation was not in existence throughout an annual accounting period (either calendar year or fiscal year) the corporation is required to make a return for that fractional part of a year during which it was in existence. A corporation is not in existence after it ceases business and dissolves, retaining no assets, whether or not under State law it may thereafter be treated as continuing as a corporation for certain limited purposes connected with winding up its affairs, such as for the purpose of suing and being sued. If the corporation has valuable claims for which it will bring suit during this period, it has retained assets, and it continues in existence. A corporation does not go out of existence if it is merely turned over to receivers or trustees who continue to operate it. 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 district director of internal revenue 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 district director of internal revenue such a corporation will be required to make a return.

(c) 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 §§ 39.51-4 and 39.51-5.

§ 39.52-2 *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 §§ 39.274-1 and 39.274-2.) 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.

§ 39.53 *Statutory provisions; returns and payment of tax; time and place for filing returns.*

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, except that in the case of the return of the fiduciary of an estate or trust, the return shall be made on or before the fifteenth day of April following the close of the calendar year. Returns made on the basis of a fiscal year shall be made on or before the fifteenth day of the third month following the close of the fiscal year, except that in the case of the return of the fiduciary of an estate or trust, the return shall be made on or before the fifteenth day of the fourth 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.

[Sec. 53 as amended by sec. 205 (b) (1), Rev. Act 1950]

§ 39.53-1 *Time for filing returns.* (a) In general, returns of income must be filed on or before the 15th day of the third full calendar month following the close of the taxable year. This rule is subject to several exceptions, in which the time for filing is as follows:

(1) In the case of a return of a nonresident alien individual (except a bona fide resident of Puerto Rico during the entire taxable year) at the time prescribed in section 217.

(2) In the case of a return of a nonresident foreign corporation, at the time prescribed in section 235.

(3) In the case of a final return of a decedent for a fractional part of a year, on or before the 15th day of the third month following the close of the 12-month period which began with the first day of such fractional part of the year.

(4) In the case of any return for a fractional part of a year, the district director may, upon a showing by the taxpayer of unusual circumstances, prescribe a later time for the filing of the return.

(5) In the case of a return of a fiduciary of an estate or trust, on or before the 15th day of the fourth month following the close of the taxable year.

(b) 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 district director of internal revenue. See also section 148 (d) and (e)

(c) For provisions relating to certain cases in which the time for filing income tax returns is postponed by reason of an individual serving in or in support of the military or naval forces of the United States in a combat zone, see section 3804. See section 3805 and § 39.3805-1 as to the time for filing income tax returns of China Trade Act corporations.

§ 39.53-2 *Extension 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 district directors of internal revenue. Application for extensions of time for filing income tax returns should be addressed to the district director of internal revenue for the internal revenue 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 §§ 39.53-3, 39.56-2, and 39.272-3.

§ 39.53-3 *Extensions of time in the case of foreign organizations, certain domestic corporations, citizens of United States residing or traveling abroad, and nontaxable returns of fiduciaries for estates or trusts.* An extension of time for filing returns of income 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 a statement must be attached to the return showing that the person for whom the return is made is a person described in this subsection.

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, if any, from the original due date until paid.

§ 39.53-4 *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 Internal Revenue Code, (including sections 3804 and 3805) and the regulations prescribed thereunder or the last day of the period covered by an extension of time granted by the Commissioner or a district director of internal revenue. 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 office of the district director of internal revenue, 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 district director of internal revenue 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 office of the district director of internal revenue on or before the due date, the envelope in which the return was transmitted will be preserved by the district director of internal revenue 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.

§ 39.53-5 *Place for filing individual returns.* (a) Section 53 (b) (1) provides that individual returns shall be made to the district director of internal revenue for the internal revenue 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 District Director of Internal Revenue at Baltimore, Md.

(b) 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 district director of internal revenue for the internal revenue district in which is located his legal residence, or, if he has no legal residence in the United States, then to the District Director of Internal Revenue at Baltimore, Md.

§ 39.54 *Statutory provisions; returns and payment of tax; records and special returns.*

SEC. 54. *Records and special returns*—(a) *By taxpayer.* Every person liable to any tax imposed by this chapter 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 chapter.

(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 should 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.

For information returns by attorneys, accountants, and so forth, as to formation, and so forth, of foreign corporations, see section 3604.

(f) Every organization, except as hereinafter provided, exempt from taxation under section 101 shall file an annual return, which shall contain or be verified by a written declaration that it is made under the penalties of perjury, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner, with the approval of the Secretary, may by regulations prescribe, and shall keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Commissioner, with the approval of the Secretary, may from time to time prescribe. No such annual return need be filed under this subsection by any organization exempt from taxation under the provisions of section 101—

(1) Which is a religious organization exempt under section 101 (6); or

(2) Which is an educational organization exempt under section 101 (6), if such organization normally maintains a regular faculty and curriculum and normally has a regularly organized body of pupils or students in attendance at the place where its educational activities are regularly carried on; or

(3) Which is a charitable organization, or an organization for the prevention of cruelty to children or animals, exempt under section 101 (6), if such organization is supported, in whole or in part, by funds contributed by the United States or any State or political subdivision thereof, or is primarily supported by contributions of the general public; or

(4) Which is an organization exempt under section 101 (6), if such organization is operated, supervised, or controlled by or in connection with a religious organization described in paragraph (1)· or

(5) Which is an organization exempt solely under section 101 (3)· or

(6) Which is an organization exempt under section 101 (15), if such organization is a corporation wholly owned by the United States or any agency or instrumentality thereof, or a wholly owned subsidiary of such a corporation.

[Sec. 54 as amended by sec. 117, Rev. Act 1943]

§ 39.54-1 *Records and income tax forms.* (a) 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 chapter 1.

In addition to such permanent books and records as are required by this paragraph with respect to the tax imposed by Supplement U (sections 421 to 424, inclusive) every organization exempt from tax under section 101 but required by section 54 (f) to file an annual return shall keep such permanent books of account or records, including inventories, as are sufficient to show specifically the items of gross income, receipts, and disbursements, and such other information as is required by § 39.101-1. The books or records required by this paragraph 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.

(b) Income-tax forms shall be prescribed by the Commissioner and shall be executed and filed in accordance with regulations in this part and the instructions on the form or issued therewith.

(c) The provisions of section 54 (f) relieving certain specified types of organizations exempt from tax under section 101 from filing annual returns do not abridge or impair in any way the powers and authority of the Commissioner provided for in other provisions of the Internal Revenue Code to require the filing of such returns by such organizations. For further regulations regarding proof and establishment of right to exemption from tax, for filing of returns, and keeping records by organizations exempt from tax, see §§ 39.101-1 and 39.153-1.

§ 39.55 *Statutory provisions; returns and payment of tax; publicity of returns.*

SEC. 55. *Publicity of returns*—(a) *Public record and inspection.* (1) Returns made under this chapter upon which the tax has been determined by the Commissioner shall constitute public records; but, except as hereinafter provided in this section, they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President.

(2) And all returns made under this chapter, subchapters A, B, D, and E of chapter 2, subchapter B of chapter 3, chapters 4, 7, 12, and 21, subchapter A of chapter 29, and chapter 30, 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.

(3) Whenever a return is open to the inspection of any person a certified copy thereof shall, upon request, be furnished to such person under rules and regulations prescribed by the Commissioner with the approval of the Secretary. The Commissioner may prescribe a reasonable fee for furnishing such copy.

(b) *Inspection by States*—(1) *State officers.* The proper officers of any State may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe.

(2) *State bodies or commissions.* All income returns filed under this chapter (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 this paragraph. 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. 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.

(c) *Inspection by shareholders.* All bona fide shareholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries.

(d) *Inspection by committees of Congress*—(1) *Committees on ways and means and finance.* (A) The Secretary and any officer or employee of the Treasury Department, upon request from the Committee on Ways and Means of the House of Representatives, the Committee on Finance of the Senate, or a select committee of the Senate or House specially authorized to investigate returns by a resolution of the Senate or House, or a joint committee so authorized by concurrent resolution, shall furnish such committee sitting in executive session with any data of any character contained in or shown by any return.

(B) Any such committee shall have the right, acting directly as a committee, or by or through such examiners or agents as it may designate or appoint, to inspect any or all of the returns at such times and in such manner as it may determine.

(C) Any relevant or useful information thus obtained may be submitted by the committee obtaining it to the Senate or the House, or to both the Senate and the House, as the case may be.

(2) *Joint Committee on Internal Revenue Taxation.* The Joint Committee on Internal Revenue Taxation shall have the same right to obtain data and to inspect returns as the Committee on Ways and Means or the Committee on Finance, and to submit any relevant or useful information thus obtained to the Senate, the House of Representatives, the Committee on Ways and Means or the Committee on Finance. The Committee on Ways and Means or the Committee on Finance may submit such information to the House or to the Senate, or to both the House and the Senate, as the case may be.

(e) *Inspection in collector's office of list of taxpayers.* The Commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal revenue district and in such other places as he may determine, lists containing the name and the post-office address of each person making an income-tax return in such district.

(f) *Penalties for disclosing information*—(1) *Federal employees and other persons.* It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provisions shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.

(2) *State employees.* Any officer, employee, or agent of any State or political subdivision, who divulges (except as authorized in paragraph 2 of subsection (b), 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 paragraph 2 of subsection (b) 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.

(3) *Shareholders.* Any shareholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both.

(4) *Cross reference.* For penalties for disclosing operations, style of work, or apparatus of any manufacturer or producer, see section 4047.

[Sec. 55 as amended by sec. 507, Second Rev. Act 1940; sec. 554 (d) (1), Rev. Act 1941]

§ 39.55-1 *Inspection of returns.* (a) Any properly authorized official, body, or commission, lawfully charged with the administration of any State tax law, or properly designated representatives of such official, body, or commission, may, in the discretion of the Commissioner, inspect income returns for the purpose of such administration. For the purposes of this section, 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.

(b) Requests for permission to inspect 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, Audit Service Branch, Washington, D. C. The request must state (1) the kind of returns it is desired to inspect, (2) the taxable year or years covered by the returns it is desired to inspect, (3) the name of the official, body, or commission by whom or which inspection is to be made, (4) the name of the representative of such official, body, or commission, designated to make the inspection, (5) 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, (6) the purpose for which the inspection is to be made, and (7) if the inspection is for the purpose of obtaining information to be furnished to local taxing authorities, (i) 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 (ii) the purpose for which the information is to be used by such official, body or commission.

(c) In any case where inspection of the returns is authorized in accordance with the provisions of this section, 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.

(d) 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 4929, approved by the President on August 28, 1939, and Treasury Decision 4945, approved September 20, 1939.

§ 39.56 *Statutory provisions; Returns and payment of tax; Payment of tax.*

SEC. 56. *Payment of tax*—(a) *Time of Payment.* The total amount of tax imposed by this chapter 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, except that in the case of the tax imposed upon an estate or trust the tax shall be paid on the fifteenth day of April 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 fourth month following the close of the fiscal year.

(b) *Installment payments*—(1) *Estates of decedents.* In the case of the estate of a decedent, the fiduciary may elect to pay the tax in four equal installments.

(2) *Corporations.* In the case of a corporation—

(A) *Taxable years ending before December 31, 1954.* The taxpayer may elect with respect to any taxable year ending before December 31, 1954, to pay the tax in four installments, and in such case the amount of the tax paid by each installment shall be determined as follows:

If the taxable year ends—		Each of the first 2 installments shall be the following percentage of the tax	And each of the last 2 installments shall be the following percentage of the tax
On or after—	And before—		
		• •	•
Dec. 31, 1951	Dec. 31, 1952	35	15
Dec. 31, 1952	Dec. 31, 1953	40	10
Dec. 31, 1953	Dec. 31, 1954	45	5

(B) *Taxable years ending on or after December 31, 1954.* The taxpayer may elect with respect to any taxable year ending on or after December 31, 1954, to pay the tax in two equal installments.

(3) *Dates for installment payments*—(A) *Four installments.* In any case in which the tax may be paid in four installments, 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 15th day of the third month, the third installment on the 15th day of the sixth month, and the fourth installment on the 15th day of the ninth month, after such date.

(B) *Two installments.* In any case in which the tax may be paid in two installments, the first installment shall be paid on the date prescribed for the payment of the tax by the taxpayer, and the second installment shall be paid on the 15th day of the third month after such date.

(4) *Requirement for payment.* If any installment is not paid on or before the date fixed for its payment, the whole 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 chapter, 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 source, see sections 143 and 144.

(g) *Fractional parts of cent.* In the payment of any tax under this chapter 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.

(i) *Payment of tax if not computed by taxpayer.* Where under section 51 (f) a taxpayer who is an individual is permitted to file return without showing the tax thereon, and the tax is to be computed by the collector, the amount determined by the collector as payable shall be paid within thirty days after the mailing by the collector to the taxpayer of a notice stating such amount and making demand thereof.

[Sec. 56 as amended by sec 172 (f) (1), Rev. Act 1942; sec. 5 (d), Current Tax Payment Act 1943; secs. 6 (b) (2), 12, Individual Income Tax Act 1944; sec. 205 (a), (b) (2), Rev. Act 1950]

§ 39.56-1 *Date on which tax shall be paid*—(a) *In general.* (1) The tax, unless it is required to be withheld at the source under section 1622, 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. See, however, paragraph (b) of this section with respect to estates and trusts and § 39.59-1 with respect to estimated tax.

(2) In any case in which an individual taxpayer is entitled to elect, and does so elect, to file as his return Form 1040A, as provided in § 39.51-2, the amount of the tax determined by the district director is to be paid within 30 days after the date of mailing by the district director to the taxpayer of a notice stating the amount payable by the taxpayer and making demand upon the taxpayer therefor.

(3) In the case of a return (other than a return by a nonresident alien individual who does not have wages subject to withholding under section 1622 or a nonresident foreign corporation) for a fractional part of a year, the tax is to be paid on or before the last day prescribed for the filing of the return (see § 39.53-1) But see § 39.53-3.

(4) For the time of payment of tax by a nonresident alien individual (except a bona fide resident of Puerto Rico subject to the provisions of section 220) who does not have wages subject to withholding under section 1622, see section 218. In the case of a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year and thus subject to the provisions of section 220, the tax is to be paid at the time provided in the case of United States citizens and residents.

(5) For the time of payment of tax by a nonresident foreign corporation, see section 236.

(6) For provisions relating to certain cases in which the time for filing income tax returns is postponed by reason of an individual serving in or in support of the military or naval forces of the United States in a combat zone, see section 3804. See section 3805 and § 39.3805-1 as to the time for filing income tax returns of China Trade Act corporations.

(b) *Estates and trusts.* In the case of the tax imposed upon an estate or trust, the tax shall be paid on or before the 15th day of April 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 fourth month following the close of the fiscal year.

(c) *Installment payments*—(1) *Estates of decedents.* With respect to estates of decedents, the fiduciary may elect to pay the tax in four equal installments, instead of in a single payment, in which case the first installment shall be paid on or before the date prescribed for the payment of the tax as a single payment, the second installment shall be paid 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.

(2) *Corporations; taxable years ending before December 31, 1954.* With respect to taxable years of corporations ending before December 31, 1954, the taxpayer may elect to pay the tax in four installments, and in such case the amount of the tax paid by each installment shall be as follows:

If the taxable year ends—		Each of the first 2 installments shall be the following percentage of the tax	And each of the last 2 installments shall be the following percentage of the tax
On or after—	And before—		
Dec. 31, 1951	Dec. 31, 1952	35	15
Dec. 31, 1952	Dec. 31, 1953	40	10
Dec. 31, 1953	Dec. 31, 1954	45	5

The first installment shall be paid on or before the date prescribed for the payment of the tax as a single payment, the second installment shall be paid 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.

(3) *Corporations; taxable year ending on or after December 31, 1954.* With respect to taxable years of corporations ending on or after December 31, 1954, the taxpayer may elect to pay the tax in two equal installments, in which case the first installment shall be paid on or before the date prescribed for the payment of the tax as a single payment and the second installment on or before the 15th day of the third month after such date.

(4) *In general.* (i) If the taxpayer elects to pay the tax in installments, 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 Internal Revenue Code 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 district director of internal revenue.

(ii) In the case of taxpayers other than estates of decedents, and other than corporations, the privilege of installment payments of the tax does not apply.

§ 39.56-2 *Extension of time for payment of the tax or part or installment thereof.* (a) If it is shown to the satisfaction of the Commissioner or the district director 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 (after August 31, 1953, the district director), 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. However, 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.

(b) An application for an extension of time for the payment of such tax should be made 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 statement of assets and liabilities of the taxpayer and an itemized statement 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 district director of internal revenue, who, if the application is filed before September 1, 1953, will transmit it to the Commissioner with his recommendations as to the extension. 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. An application for an extension of time for the payment of a tax will not be considered unless request therefor is made to the district director of internal revenue on or before the date prescribed for payment of the tax or any part 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.

(c) As a condition to the granting of such an extension, the taxpayer will usually be required 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 any part 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 any part or installment thereof. See 6 U. S. C. 15. 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 part or installment thereof, 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.

§ 39.56-3 *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.

§ 39.56-4 *Receipts for tax payments.* Upon request a district director of internal revenue 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 district director of internal revenue should furnish a receipt.

§ 39.57 *Statutory provisions; returns and payment of tax; examination of returns and determination of tax.*

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.

§ 39.57-1 *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.

§ 39.58 (a) *Statutory provisions; returns and payment of tax; declaration of estimated tax by individuals; requirement of declaration.*

SEC. 58. *Declaration of estimated tax by individuals*—(a) *Requirement of declaration.* Every individual (other than an estate or trust and other than a nonresident alien with respect to whose wages, as defined in section 1621 (a), withholding under Subchapter D of Chapter 9 is not made applicable, but including every alien individual who is a resident of Puerto Rico during the entire taxable year) shall, at the time prescribed in subsection (d), make a declaration of his estimated tax for the taxable year if—

(1) His gross income from wages (as defined in section 1621) can reasonably be expected to exceed the sum of $4,500 plus $600 with respect to each exemption provided in section 25 (b); or

(2) His gross income from sources other than wages (as defined in section 1621) can reasonably be expected to exceed $100 for the taxable year and his gross income to be $600 or more.

[Sec. 58 (a) as amended by sec. 5 (a), Current Tax Payment Act 1943; sec. 13 (a), Individual Income Tax Act 1944; sec. 102 (b) (4), Rev. Act 1945; sec. 202 (a), Rev. Act 1948; sec. 221 (g), Rev. Act 1950]

§ 39.58 (a)-1 *Declarations of estimated tax.* (a) A declaration of estimated tax shall be made by every citizen of the United States, whether residing at home or abroad, every individual residing in the United States though not a citizen thereof, every nonresident alien who is a resident of Canada, Mexico, or Puerto Rico and who has wages subject to withholding at the source under section 1622, and every nonresident alien who has been, or expects to be, a resident of Puerto Rico during the entire taxable year, if such citizen or resident or alien can reasonably be expected to have for such taxable year:

(1) Gross income from wages subject to withholding under section 1622 in excess of the sum of $4,500 plus $600 for each exemption allowable as a credit under section 25 (b) or

(2) Gross income of more than $100 from sources other than wages subject to withholding under section 1622 and total gross income of $600 or more.

(b) In the case of a husband and wife, whether or not they are living together, a joint declaration of estimated tax may be made if the gross income of either spouse meets the requirements of section 58 (a) If the gross income of each spouse meets the requirements of section 58 (a) either a joint declaration must be made or a separate declaration must be made by each. For the purpose of determining whether a declaration of estimated tax is required under the provisions of section 58 (a) a married person may not take into account the exemption of his spouse, if his spouse has, or is reasonably expected to have, gross income.

(c) In estimating his gross income for the taxable year a parent should not take into account the income of his minor child. Such income is not includible in the gross income of the parent. See section 22 (m)

(d) A nonresident alien who is (1) a resident of Canada or Mexico, who enters into and leaves the United States at frequent intervals, or (2) a resident of Puerto Rico, and who has wages subject to withholding under the provisions of section 1622 is required to file a declaration of estimated tax if his gross income meets the requirements of section 58 (a) In the case of a nonresident alien (other than an alien resident of Puerto Rico for the entire taxable year) gross income means only gross income from sources within the United States. See sections 212 (a) and 220. As to what constitutes gross income from sources within the United States, see section 119 and the regulations thereunder. Thus, for example, a nonresident alien over the age of 65 years, living in Mexico with his wife and one dependent child throughout 1952, makes his return on a calendar year basis. His wife and child are also nonresident aliens. He is employed as an executive in El Paso, Texas, at a salary of $8,000 per annum and enters and leaves the United States at frequent intervals in pursuit of such employment. Neither husband nor wife has any reasonable expectation of any other income from United States sources. Since his wages derived from sources within the United States in 1952 can reasonably be expected to amount to more than $4,500 plus $2,400 (the aggregate of four exemptions, including one exemption for old age) or $6,900, a declaration of estimated tax must be filed for such resident of Mexico for 1952.

(e) A nonresident alien who has been, or expects to be, a resident of Puerto Rico during the entire taxable year is required to file a declaration of estimated tax if his gross income meets the requirements of section 58 (a) For the purpose of such declaration, gross income means gross income from all sources, other than sources within Puerto Rico, but including amounts received for services performed as an employee of the United States or any agency thereof. See sections 116 (l) and 220.

(f) An estate or trust, though generally taxed as an individual, is not within the scope of the system of current payment of the tax, and hence is not required to file a declaration.

(g) The application of these provisions may be illustrated by the following examples:

Example (1). H, a taxpayer making his return on the calendar year basis, is married and has two dependent children. Neither his wife nor his children have any source of income. H's wife has been blind for several years and it is reasonable to assume that she will not regain her sight in 1952. H's salary from January 1 to June 30, 1952, is at the annual rate of $7,000. However, effective July 1, 1952, his annual salary is increased to $9,000 and under the facts then existing it is reasonable to assume that his salary for the remaining portion of 1952 will remain unchanged and that his total salary for the year will, therefore, be $8,000. Since such amount is in excess of $4,500 plus $3,000 (the aggregate of five exemptions, including the two exemptions for the blind spouse), or $7,500, H is required to file a declaration of estimated tax for 1952. As to when such declaration is required to be filed, see § 39.58(d)-1(a).

Example (2). P, a professional man engaged in the practice of his profession on his own account, has gross income of $400 from such profession for the two months of January and February 1952. It can reasonably be expected that he will have no income during 1952 from any other source. Since P has gross income which can for 1952 reasonably be expected to exceed $600 and such income does not constitute wages subject to withholding, he is required to file a declaration of estimated tax regardless of his marital status and regardless of the number of exemptions to which he may be entitled for that year.

Example (3). S has been regularly employed for many years prior to January 1, 1952, at which date his weekly wage is $50. S also owns stock in a corporation from which he has derived regularly for many years prior to 1952 annual dividends ranging from $120 to $160. In view of the fact that for 1952 S can reasonably be expected to receive gross income of $600 or more, which includes more than $100 of income from sources other than wages as defined in section 1621 (a), he is required to make a declaration of estimated tax for such year regardless of his marital status or the number of exemptions to which he may be entitled.

Example (4). T, a married taxpayer, who makes his return on the calendar year basis, is employed at the beginning of 1952 at an annual salary of $7,500, which, on the basis of facts then existing, will, it is expected, not undergo any change throughout 1952. His wife owns stock upon which dividends ranging from $75 to $100 have been paid regularly during the years before 1952. T has two dependent children, one of whom has no source of income in 1952; the other child, however, is employed on a part-time basis and may reasonably be expected to receive compensation of $650 in 1952. T also contributes the major portion of the support of his mother whose only source of income is approximately $100 per year from a trust fund. Under these facts for the purpose of determining whether he is required to file a declaration, T may take into account only three exemptions, one for himself, one for his mother, and one for the child expected to receive less than $600 gross income in 1952. Since his expected salary of $7,500 exceeds the sum of $4,500 plus $1,800 (three exemptions), or $6,300, T is required to file a declaration of estimated tax for 1952. In computing his estimated tax on a separate declaration, T may not take into account any exemption for his wife since she is reasonably expected to have gross income in 1952. If, however, a joint declaration is made and the tax is estimated on the basis of the aggregate net income, account may be taken of an exemption for the wife.

§ 39.58 (b) *Statutory provisions; returns and payment of tax; declaration of estimated tax by individuals; contents of declaration.*

SEC. 58. *Declaration of estimated tax by individuals.* * * *

(b) *Contents of declaration.* In the declaration required under subsection (a) the individual shall state—

(1) The amount which he estimates as the amount of tax under this chapter for the taxable year, without regard to any credits under sections 32 and 35 for taxes withheld at source and without regard to the tax imposed by subchapter E on self-employment income;

(2) The amount which he estimates as the credits for the taxable year under sections 32 and 35; and

(3) The excess of the amount estimated under paragraph (1) over the amount estimated under paragraph (2), which excess for the purposes of this chapter shall be considered the estimated tax for the taxable year.

The declaration shall also contain such other information for the purposes of carrying out the provisions of this chapter as the Commissioner, with the approval of the Secretary, may by regulations prescribe, and shall contain or be verified by a written statement that it is made under the penalties of perjury.

[Sec. 58 (b) as amended by sec. 5 (a), Current Tax Payment Act 1943; sec. 13 (a), Individual Income Tax Act 1944; sec. 208 (d) (4), Social Security Act Amendments 1950]

§ 39.58 (b)-1 *Form and contents of declaration of estimated tax*—(a) *In general.* (1) The declaration of estimated tax shall be on Form 1040-ES. The form may be obtained from the district directors of internal revenue of the several districts. It shall be executed, verified, and filed in accordance with the regulations in this part and the instructions on the form issued therewith. For the purposes of making the declaration, the amount of gross income which the taxpayer can reasonably be expected to receive or accrue, as the case may be, depending upon the method of accounting upon the basis of which the net income is computed, and the amount of the estimated allowable deductions and credits to be taken into account in computing the amount of the estimated tax, shall be determined upon the basis of facts and circumstances existing as at the time prescribed for the filing of the declaration. If, therefore, the taxpayer is employed at the date of filing his declaration at a given wage or salary, it should, in the absence of circumstances indicating the contrary, be presumed by him for the purposes of the declaration that such employment will continue to the end of the taxable year at the wage or salary received by him as at the date of making the declaration. In the case of the recipient of income other than wages the regularity in the payment of income, such as dividends, interests, rents, royalties, and income arising from estates and trusts is a factor to be taken into consideration. Thus, if the taxpayer owns shares of stock in the X Corporation and dividends have been paid regularly for several years upon such stock, the taxpayer in the preparation of his schedules preliminary to the execution of Form 1040-ES should, in the absence of information indicating a change in the dividend policy, include the prospective dividends from the X Corporation for the taxable year as well as those actually received in such year prior to the filing of the declaration. In the case of a taxpayer engaged in business on his own account, there shall be made an estimate of gross income and deductions and credits in the light of the best available information affecting the trade, business, or profession.

(2) In the case of any individual who can, at the time of the preparation of Form 1040-ES, reasonably anticipate that his gross income will be of such amount and character as to enable him to elect upon his return for such year to compute the tax under section 400 in lieu of the normal tax and surtax, the declaration of estimated tax may be made upon the basis set forth in section 400 and § 39.400-1. The filing of a declaration computed upon the basis of section 400 shall not constitute an election under section 402 and shall not permit the filing of a return under section 400 unless the taxpayer comes within the provisions of sections 400 and 401. For the purposes of computing the tax liability under chapter 1 in the case of married persons, if the net income of one spouse is determined without regard to the standard deduction, the standard deduction is not allowed to either. (See, however, § 39.23 (aa)-1 (c) for exceptions where spouses are legally separated or are not living together.) Hence, to avoid the risk of underestimating the tax in such case, one spouse should not use section 400 in computing the estimated tax unless the other spouse also uses section 400 or employs the standard deduction in computing the estimated tax.

(3) The declaration may be made by an agent if, by reason of illness, the person liable for the making of the declaration is unable to make it. The declaration may also be made by an agent if the taxpayer is unable to make the declaration by reason of continuous absence from the United States (including Puerto Rico as if a part of the United States) for a period of at least 60 days prior to the date prescribed by law for making the declaration. Whenever a declaration is made by an agent it must be accompanied by the prescribed power of attorney, Form 935, except that an agent holding a valid and subsisting general power of attorney authorizing him to represent his principal in making, executing, and filing the declaration, may submit a certified copy thereof in lieu of the authorization on Form 935. The taxpayer and his agent, if any, are responsible for the declaration as made and incur liability for the penalties provided for erroneous, false, or fraudulent declarations.

(4) The home or residential address of the taxpayer (including the street and number, if any) shall be given in the space provided on the form. 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.

(b) *Contents of declaration.* The declaration shall contain (1) the amount estimated as the tax for the taxable year after the application of the credit for foreign tax, if any, but without regard to the credits under sections 32 and 35; (2) the amount estimated by the taxpayer as the sum of the credits under such sections; and (3) the excess, if any, of the amount shown under (1) over the amount shown under (2), which excess shall be the estimated tax for such taxable year. The estimated tax need not include an amount estimated as the tax on self-employment income imposed by section 480.

§ 39.58 (b)-2 *Use of prescribed forms.* Copies of the prescribed declaration forms will so far as possible be furnished taxpayers by district directors of internal revenue. A taxpayer will not be excused from making a declaration, however, by the fact that no declaration form has been furnished to him. Taxpayers not supplied with the proper forms should make application therefor to the district director of internal revenue in ample time to have their declarations prepared, verified, and filed with the district director of internal revenue on or before the due date. Each taxpayer should carefully prepare his declaration so as to set forth fully and clearly the data therein called for. If the prescribed form is not available, a statement disclosing his estimated income tax, his estimated credits, and his estimated tax after deducting such credits may be accepted as a tentative declaration, and if filed within the prescribed time, accompanied by the payment of the required installment, the statement so made will relieve the taxpayer from liability to penalties, *Provided,* That without unnecessary delay such a tentative declaration is supplemented by a declaration made on the proper form.

§ 39.58 (c) *Statutory provisions; returns and payment of tax; declaration of estimated tax by individuals; joint declaration by husband and wife.*

SEC. 58. *Declaration of estimated tax by individuals.* * * *

(c) *Joint declaration by husband and wife.* In the case of a husband and wife, a single declaration under this section may be made by them jointly, in which case the liability with respect to the estimated tax shall be joint and several. No joint declaration may be made if either the husband or wife is a nonresident alien. If a joint declaration is made but a joint return is not made for the taxable year, the estimated tax for such year may be treated as the estimated tax of either the husband or the wife, or may be divided between them.

[Sec. 58 (c) as added by sec. 5 (a), Current Tax Payment Act 1943; as amended by sec. 13 (a), Individual Income Tax Act 1944]

§ 39.58 (c)-1 *Joint declarations by husband and wife.* (a) A husband and wife may make a joint declaration even though they are not living together. A joint declaration may not be made after the death of either the husband or wife or if either the husband or wife is a nonresident alien, including such an alien who is a bona fide resident of Puerto Rico during the entire taxable year. However, if it is reasonable for a surviving spouse to assume that there will be filed a joint return for himself and the deceased spouse for taxable years which include the last taxable year of the deceased spouse, he may, in making a separate declaration for his taxable year which includes the period comprising such last taxable year of his spouse, estimate net income on an aggregate basis and compute his estimated tax in the same manner as though a joint declaration had been filed. For computation of tax in case of a joint return, see § 39.12-3.

(b) A joint declaration of a husband and wife, if not made by an agent (see

§ 39.51-2) shall be signed by both spouses. If signed by one spouse as agent for the other, authorization for such action must accompany the declaration. The spouse acting as agent for the other shall, with the principal, assume the responsibility for making the declaration and incur liability for the penalties provided for erroneous, false, or fraudulent declarations.

(c) If a joint declaration is made by husband and wife, the liability with respect to the estimated tax shall be joint and several. The fact that a joint declaration of estimated tax is made by them will not preclude a husband and his wife from filing separate returns. In case a joint declaration is made but a joint return is not made for the same taxable year, the payments made on account of the estimated tax for such year may be treated as payments on account of the tax liability of either the husband or wife for the taxable year or may be divided between them in any manner they see fit.

(d) If a joint declaration is made by husband and wife and thereafter one spouse dies, no further payments of estimated tax on account of such joint declaration are required from the estate of the decedent. The surviving spouse, however, shall be liable for the payment of subsequent installments of the joint estimated tax unless an amended declaration setting forth the separate estimated tax for the taxable year is filed by such spouse. Such separate estimated tax shall be paid at the time and in the amounts determined under the rules prescribed in § 39.59-1. For the purposes of the amended declaration, the payments made pursuant to the joint declaration may be divided between the decedent and the surviving spouse in such proportion as the surviving spouse and the legal representative of the decedent may agree.

§ 39.58 (d) *Statutory provisions; returns and payment of tax; declaration of estimated tax by individuals; time and place for filing.*

SEC. 58. *Declaration of estimated tax by individuals.* * * *

(d) *Time and place for filing*—(1) *In general.* The declaration required under subsection (a) shall be filed on or before March 15 of the taxable year, except that if the requirements of section 58 (a) are first met

(A) after March 1 and before June 2 of the taxable year, the declaration shall be filed on or before June 15 of the taxable year, or

(B) after June 1 and before September 2 of the taxable year, the declaration shall be filed on or before September 15 of the taxable year, or

(C) after September 1 of the taxable year, the declaration shall be filed on or before January 15 of the succeeding taxable year.

(2) *Amendment of declaration.* An individual may make amendments of a declaration filed during the taxable year under this subsection, under regulations prescribed by the Commissioner with the approval of the Secretary. If so made, such amendments may be filed on or before the fifteenth day of the last month of any quarter of the taxable year subsequent to that in which the declaration was filed and in which no previous amendment has been filed, except that in the case of an amendment filed after September 15 of the taxable year, it may be filed on or before January 15 of the succeeding taxable year. Declarations and amendments thereof shall be filed with the collector specified in section 53 (b) (1).

(3) *Return as declaration or amendment.* If on or before January 15 of the succeeding taxable year the taxpayer files a return, for the taxable year for which the declaration is required, and pays in full the amount computed on the return as payable, then, under regulations prescribed by the Commissioner with the approval of the Secretary—

(A) If the declaration is not required to be filed during the taxable year, but is required to be filed on or before such January 15, such return shall, for the purposes of this chapter, be considered as such declaration; and

(B) If the tax shown on the return (reduced by the credits under sections 32 and 35) is greater than the estimated tax shown in a declaration previously made, or in the last amendment thereof, such return shall, for the purposes of this chapter, be considered as the amendment of the declaration permitted by paragraph (2) to be filed on or before such January 15.

[Sec. 58 (d) as added by sec. 5 (a), Current Tax Payment Act 1943; amended by sec. 13 (a), Individual Income Tax Act 1944]

§ 39.58 (d)-1 *Time and place for filing declarations*—(a) *Time for filing declaration.* (1) Declarations of estimated tax for the calendar year shall (except in the case of farmers, as to whom see § 39.60-1) be made on or before March 15th of such year by every individual whose then anticipated income for the current calendar year meets the requirements of section 58 (a) If, however, the requirements necessitating the filing of the declaration are first met, in the case of a taxpayer on the calendar year basis, after March 1st, but before June 2d of the calendar year, the declaration must be filed on or before June 15th; if such requirements are first met after June 1st and before September 2d, the declaration must be filed on or before September 15th; and if such requirements are first met after September 1st, the declaration must be filed on or before January 15th of the succeeding calendar year. In the case of a taxpayer on the fiscal year basis, see § 39.60-3.

(2) The requirements with respect to the filing of the declaration are those prescribed in section 58 (a) The requirements with respect to the time for filing the declaration apply alike to such nonresident aliens as are required to make a declaration as well as to United States citizens and residents. In the case of certain individuals, serving in or in support of the military or naval forces of the United States in a combat zone, the provisions of section 3804 relative to the time for filing returns are also applicable with respect to the time for filing declarations. In the case of any such individual, however, if the time for filing the return for a taxable year is postponed under section 3804, a declaration of estimated tax for such taxable year is not required.

(b) *Place for filing declaration.* (1) The declaration of estimated tax and amendments and revisions thereof shall be filed with the district director of internal revenue for the internal revenue district in which is located the legal residence or principal place of business of the person making the declaration, or if he has no legal residence or principal place of business in the United States, then with the district director of internal revenue at Baltimore, Md. Any amended declaration shall be filed with the district director of internal revenue for the internal revenue district in which the original declaration was filed.

(2) 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 this paragraph and shall make his declaration to the district director of internal revenue for the internal revenue district in which is located his legal residence, or if he has no legal residence in the United States then to the district director of internal revenue at Baltimore, Md.

(c) *Amended declarations.* In the making of a declaration of estimated tax, the statute requires the taxpayer to take into account the then existing facts and circumstances as well as those reasonably to be anticipated relating to prospective gross income, allowable deductions, and estimated credits for the taxable year. Amended or revised declarations may be made in any case in which the taxpayer estimates that his gross income, deductions, or credits will differ from the gross income, deductions, or credits reflected in the previous declaration. An amended declaration may also be made based upon a change in the number of exemptions to which the taxpayer may be entitled for the then current taxable year. An amended declaration may be filed jointly by husband and wife even though separate declarations have previously been filed. Such amended declaration shall be on Form 1040-ES, marked "Amended." No amended or revised declaration may be filed in the quarter in which the original declaration has been filed nor in any subsequent quarter in which a prior or revised declaration has been filed. Where an original declaration has previously been filed: In the case of a taxpayer on the calendar year basis, an amended declaration to be filed after September 15 may be filed on or before January 15 of the succeeding calendar year; in the case of a taxpayer on the fiscal year basis, an amended declaration to be filed after the 15th day of the ninth month of such fiscal year may be filed on or before the 15th day of the succeeding fiscal year. Thus, if a taxpayer is on a fiscal year basis beginning July 1, 1952, an amended declaration to be filed after March 15, 1953, may be filed on or before July 15, 1953.

(d) *Return as a declaration of estimated tax or amendment thereof.* (1) If the taxpayer files his return for the calendar year on or before January 15th (in the case of a farmer, January 31st, see § 39.60-1) of the succeeding calendar year (or if the taxpayer is on a fiscal year basis (see § 39.60-3), on or before the 15th day (in the case of a farmer, the last day) of the first month immedi-

ately succeeding the close of such fiscal year—see § 39.60-3 (b)) and pays in full the amount of tax shown by such return as payable, then:

(i) Such return shall be considered also as a declaration for such taxable year if, in such case, the taxpayer first met the requirements of section 58 (a) (relating to the requirements with respect to filing of declarations) after September 1st of the taxable year (or the 1st day of the ninth month of the taxable year if the taxpayer is on a fiscal year basis) and

(ii) If the tax shown on such return differs from the estimated tax shown in the previously filed declaration, such return shall be considered as an amended declaration the filing of which before the 15th day of the first month following the close of the taxable year is permitted by section 58 (d) (2)

Hence, for example, an individual taxpayer on the calendar year basis who, subsequent to September 1, 1952, first meets the requirements of section 58 (a) which necessitate the filing of such declaration in 1952, may satisfy the requirements as to the filing of such declaration by filing his return for 1952 on or before January 15, 1953, and paying in full at the time of such filing the tax shown thereon to be payable.

(2) Likewise, if a taxpayer files on or before September 15th a timely declaration for such year and subsequent thereto and on or before January 15th of the succeeding taxable year (or corresponding date in the case of a taxpayer on the fiscal year basis) files his return for such year, and pays at the time of filing the tax shown by the return to be payable, such return shall be treated as an amended declaration timely filed.

(3) For the purposes of section 58 (d) (3) a taxpayer may file his return, Form 1040, on or before the 15th day of the first month following the close of the taxable year even though he has not been furnished Form W-2 by his employer. In such case the taxpayer shall compute, as accurately as possible, his wages for such year and the tax withheld for which he is entitled to a credit, reporting such wages and tax on his return, Form 1040, together with all other pertinent information necessary to the determination of his tax liability for such year.

§ 39.58 (e) *Statutory provisions; returns and payment of tax; declaration of estimated tax by individuals; extension of time.*

SEC. 58. *Declaration of estimated tax by individuals.* * * *

(e) *Extension of time.* The Commissioner may grant a reasonable extension of the time for filing declarations and paying the estimated tax, 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.

[Sec. 58 (e) as added by sec. 5 (a), Current Tax Payment Act 1943; amended by sec. 13 (a), Individual Income Tax Act 1944]

§ 39.58 (e)-1 *Extension of time for filing declarations.* (a) It is important that the taxpayer render on or before the due date a declaration of estimated tax as accurate as the facts and circumstances then existing or reasonably to be anticipated permit. However, the Commissioner is authorized to grant a reasonable extension of time for filing declarations under such rules and regulations as he shall prescribe with the approval of the Secretary. Accordingly, authority for granting extensions of time for filing declarations is hereby delegated to the various district directors of internal revenue. Applications for extensions of time for filing declarations shall be addressed to the district director of internal revenue for the internal revenue district in which the taxpayer files his income tax 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 declarations may be granted for more than six months.

(b) An extension of time for filing the declaration of estimated tax otherwise due on or before the 15th day of the third month of the taxable year is hereby granted to and including the 15th day of the sixth month of the taxable year in the case of United States citizens outside continental United States, Hawaii, and Puerto Rico on the 15th day of the third month of the taxable year.

(c) An extension of time for filing the declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period.

§ 39.58 (f)-(h) *Statutory provisions; returns and payment of tax; declaration of estimated tax by individuals; persons under disability; signatures presumed correct; publicity of declaration.*

SEC. 58. *Declaration of estimated tax by individuals.* * * *

(f) *Persons under disability.* If the taxpayer is unable to make his own declaration, the declaration 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.

(g) *Signatures presumed correct.* The fact that an individual's name is signed to a filed declaration shall be prima facie evidence for all purposes that the declaration was actually signed by him.

(h) *Publicity of declaration.* For the purposes of section 55 (relating to publicity of returns), a declaration of estimated tax shall be held and considered a return under this chapter.

[Sec. 58 (f) to (h) as added by sec. 5 (a), Current Tax Payment Act 1943]

§ 39.58 (h)-1 *Publicity of returns.* The declaration of estimated tax constitutes, within the meaning of section 55, a return. Hence, the rules provided under that section with respect to publicity of returns are equally applicable to declarations of estimated tax. See section 55 and § 39.55-1.

§ 39.59 *Statutory provisions; returns and payment of tax; payment of estimated tax.*

SEC. 59. *Payment of estimated tax*—(a) *In general.* The estimated tax shall be paid as follows:

(1) If the declaration is filed on or before March 15 of the taxable year, the estimated tax shall be paid in four equal installments. The first installment shall be paid at the time of the filing of the declaration, the second and third on June 15 and September 15, respectively, of the taxable year, and the fourth on January 15 of the succeeding taxable year.

(2) If the declaration is filed after March 15 and not after June 15 of the taxable year, and is not required by section 58 (d) to be filed on or before March 15 of the taxable year, the estimated tax shall be paid in three equal installments. The first installment shall be paid at the time of the filing of the declaration, the second on September 15 of the taxable year, and the third on January 15 of the succeeding taxable year.

(3) If the declaration is filed after June 15 and not after September 15 of the taxable year, and is not required by section 58 (d) to be filed on or before June 15 of the taxable year, the estimated tax shall be paid in two equal installments. The first installment shall be paid at the time of the filing of the declaration, and the second on January 15 of the succeeding taxable year.

(4) If the declaration is filed after September 15 of the taxable year, and is not required by section 58 (d) to be filed on or before September 15 of the taxable year, the estimated tax shall be paid in full at the time of the filing of the declaration.

(5) If the declaration is filed after the time prescribed in section 58 (d) (including cases in which an extension of time for filing the declaration has been granted under section 58 (e)), paragraphs (2), (3), and (4) of this subsection shall not apply, and there shall be paid at the time of such filing all installments of estimated tax which would have been payable on or before such time if the declaration had been filed within the time prescribed in section 58 (d), and the remaining installments shall be paid at the times at which, and in the amounts in which, they would have been payable if the declaration had been so filed.

(b) *Amendments of declaration.* If any amendment of a declaration is filed, the remaining installments, if any, shall be ratably increased or decreased, as the case may be, to reflect the increase or decrease, as the case may be, in the estimated tax by reason of such amendment, and if any amendment is made after September 15 of the taxable year, any increase in the estimated tax by reason thereof shall be paid at the time of making such amendment.

(c) *Installments paid in advance.* At the election of the individual, any installment of the estimated tax may be paid prior to the date prescribed for its payment.

(d) *Payment as part of tax for taxable year.* Payment of the estimated tax, or any installment thereof, shall be considered payment on account of the tax for the taxable year. Assessment in respect to the estimated tax shall be limited to the amount paid.

[Sec. 59 as amended by sec. 5 (a), Current Tax Payment Act 1943; sec. 13 (a), Individual Income Tax Act 1944]

§ 39.59-1 *Payment of estimated tax*—(a) *In general.* (1) Section 59 (a) provides the following rules governing the time for payment of the estimated tax for calendar years:

Date of filing declaration	*Dates of payment of estimated tax*
(1) On or before March 15	In four equal installments—one at time of filing declaration, one not later than June 15, one not later than September 15, and one not later than January 15 of the succeeding taxable year.

(ii) After March 15 and before June 16 and not required to be filed on or before March 15.	In three equal installments—one at time of filing declaration, one on or before September 15, and one on or before January 15 of the succeeding taxable year.
(iii) After June 15 and before September 16 and not required to be filed on or before June 15.	In two equal installments—one at time of filing declaration, and the other on or before January 15 of the succeeding taxable year.
(iv) After September 15 and not required to be filed on or before that date.	In full at time of filing declaration.

(2) If, for example, due to the nature and amount of his gross income and his then existing marital status for 1952, the taxpayer is not required to file his declaration as of March 15, but is required to file on or before June 15, 1952, the case comes within the scope of subdivision (ii) of subparagraph (1) of this paragraph and the estimated tax is payable in full at the time of filing the declaration or, in the alternative, in three equal installments, one on the date of filing, one on or before September 15, 1952, and the third installment on or before January 15, 1953.

(3) Notwithstanding the rules set forth in subparagraph (1) of this paragraph relating to the time for payment of the estimated tax, section 59 provides that if in any case a declaration is filed after the time prescribed in section 58 (d) (including a case in which such filing is due to an extension of time granted for filing the declaration) the estimated tax shall be paid at the time of filing the declaration or, in the alternative, there shall be paid at such time all installments of the estimated tax which would have been payable on or before such date of filing if the declaration had been timely filed in accordance with the provisions of section 58 (d) and the remaining installments shall be paid at the times and in the amounts in which they would have been payable if the declaration had been so filed. Thus, for example, A, a married man who makes his return on the calendar year basis, was employed from the beginning of 1952 and for several years prior thereto at an annual salary of $6,000, thus meeting the requirements of section 58 (a) A filed his declaration for 1952 on September 16, 1952. In such case, A should have filed a declaration on or before March 15, 1952, and at the time of filing his declaration he was delinquent in the payment of three installments of his estimated tax for the taxable year 1952. Hence, upon his filing the declaration on September 16, 1952, three-fourths of the estimated tax shown thereon must be paid.

(4) In the case of a taxpayer on the fiscal year basis, there shall be substituted for the dates March 15, June 15, September 15, and January 15 of the succeeding taxable year, the 15th day of the third month, the 15th day of the sixth month, and the 15th day of the ninth month of the taxable year and the 15th day of the first month of the succeeding taxable year, respectively. For example, if a taxpayer on the fiscal year basis ending June 30, 1953, first meets on January 15, 1953, the requirements of section 58 (a) and the declaration is filed on or before March 15, 1953, the estimated tax shall be paid in two equal installments, one at the time of filing of such declaration and the second on or before July 15, 1953.

(5) In the case of a decedent, payments of estimated tax are not required subsequent to the date of death. See, however, § 39.58 (c)-1 for requirement of amended declaration by surviving spouse if a joint declaration was made with decedent before death.

(6) At the election of the taxpayer any installment of the estimated tax may be paid prior to the date prescribed for its payment.

(7) The payment of any and every installment of the estimated tax shall be considered payment on account of the tax for such taxable year. Hence, upon the return for such taxable year, the aggregate amount of the payments of estimated tax should be entered as payments to be applied against the tax shown on such return.

(b) *Farmers.* In the case of an individual whose estimated gross income from farming is at least two-thirds of his total gross income from all sources for the taxable year, special provisions are made with respect to the filing of the declaration, the payment of the tax, and the penalties incurred. As to what constitutes income from farming within the meaning of this paragraph, see § 39.60-1(a) In such case, if such taxable year is the calendar year, the declaration is to be filed on or before January 15 of the succeeding calendar year and payment of the estimated tax shall be made in full at such time. In the case of a farmer on the fiscal year basis, the declaration may be filed on or before the 15th day of the succeeding fiscal year and payment of the estimated tax shall be made in full at such time.

(c) *Short taxable years.* (1) In the case of a short taxable year for which a declaration is required to be filed the estimated tax shall be paid in equal installments, one at the time of filing the declaration, one on the 15th day of the third month of each succeeding 3-month period contained in such short taxable year except the last such 3-month period or fraction thereof, and one on the 15th day of the first month of the succeeding taxable year. For example, if the short taxable year is the period of 10 months from January 1, 1952, to October 31, 1952, and the declaration is required to be filed on or before March 15, 1952, the estimated tax is payable in four equal installments, on the date of filing the declaration, June 15, September 15, and November 15. If in such case the declaration is required to be filed after March 15 but on or before June 15, the tax will be payable in three equal installments, on the date of filing the declaration, September 15, and November 15.

(2) The provisions of paragraph (a) of this section relating to payment of estimated tax in any case in which the declaration is filed after the time prescribed in section 58 (d) are equally applicable to the payment of the estimated tax for short taxable years.

§ 39.60 *Statutory provisions; returns and payment of tax; special rules for application of sections 58 and 59.*

SEC. 60. *Special rules for application of sections 58 and 59*—(a) *Farmers.* In the case of an individual whose estimated gross income from farming for the taxable year is at least two-thirds of the total estimated gross income from all sources for the taxable year, in lieu of the time prescribed in section 58 (d), the declaration for the taxable year may be made at any time on or before January 15 of the succeeding taxable year; and if such an individual files a return on or before January 31 of the succeeding taxable year, and pays in full the amount computed on the return as payable, such return shall have the same effect as that prescribed in section 58 (d) (3) in the case of a return filed on or before January 15.

(b) *Application to short taxable years.* The application of sections 58, 59, and 294 (d) and of subsection (a) of this section, to taxable years of less than twelve months shall be as prescribed in regulations prescribed by the Commissioner with the approval of the Secretary.

(c) *Fiscal years.* In the application of sections 58 and 59, and subsection (a) of this section, to the case of a taxable year beginning on any date other than January 1, there shall be substituted, for the months specified therein, the months which correspond thereto.

[Sec. 60 as amended by sec. 5 (a), Current Tax Payment Act 1943; sec. 118 (b), Rev. Act 1943; sec. 13 (a), Individual Income Tax Act 1944; sec. 1, Pub. Law 378 (81st Cong.)]

§ 39.60-1 *Farmers*—(a) *General rule.* In the case of an individual, whose estimated gross income from farming for the taxable year is at least two-thirds of his total estimated gross income from all sources for such taxable year, his declaration may be filed on or before the 15th day of January of the succeeding taxable year in lieu of the time prescribed for individuals generally. The estimated gross income from farming is the estimated income resulting from the cultivation of the soil and the raising or harvesting of any agricultural or horticultural commodities, and the raising of livestock, bees, or poultry. In other words, the requisite gross income must be derived from the operations of a stock, dairy, poultry, fruit, or truck farm, or plantation, ranch, nursery, range or orchard. If an individual receives for the use of his land income in the form of a share of the crops produced thereon, such income is from farming. As to determination of income of farmers, see §§ 39.22 (a)-7 and 39.23 (a)-11.

(b) *Short taxable years.* In the case of an individual whose estimated gross income from farming for a short taxable year is at least two-thirds of his total estimated gross income from all sources for such taxable year, his declaration may be filed on or before the 15th day

of the month immediately following the close of such taxable year.

§ 39.60-2 *Short taxable years*—(a) *Requirement of declaration.* No declaration may be made for a period of more than 12 months. A separate declaration for a fractional part of a year is, therefore, required where, for example, 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 declarations in the several cases are those set forth in section 47 (a) No declaration, however, is required for a taxable year of less than three months. If the short taxable year is a period:

(1) Of at least three months but less than six months and the requirements of section 58 (a) are first met after the 1st day of the third month, or

(2) Of at least six months but less than nine months and the requirements of section 58 (a) are first met after the 1st day of the sixth month, or

(3) Of nine months or more and the requirements of section 58 (a) are first met after the 1st day of the ninth month,

no declaration is required. In the case of a decedent, no declaration need be filed subsequent to the date of death. As to requirement for amended declaration if death of one spouse occurs after filing a joint declaration, see § 39.58 (c)-1.

(b) *Income placed on annual basis.* For the purpose of determining whether the anticipated income for a short taxable year necessitates the filing of a declaration, such income shall be placed on an annual basis in the manner prescribed in section 47 (c) (1) Thus, for example, a taxpayer who changes from a calendar year basis to a fiscal year basis beginning July 1, 1952, will have a short taxable year beginning January 1, 1952, and ending June 30, 1952. If his anticipated gross income for such short taxable year consists solely of wages (as defined in section 1621 (a)) in the amount of $3,000, his total gross income and his gross income from such wages for the purpose of determining whether a declaration is required is $6,000, the amount obtained by placing anticipated income of $3,000 upon an annual basis. Hence, assuming such taxpayer is single and has no dependents, he is required to file a declaration of estimated tax for the short taxable year since his anticipated gross income from wages when placed upon an annual basis is in excess of $5,100 ($4,500 plus $600)

(c) *Time for filing declaration.* In the case of short taxable years the declaration shall be filed on or before the 15th day of the third month of such taxable year if the requirements of section 58 (a) are met on or before the 1st day of the third month of such year. If such requirements are first met after the 1st day of the third month but before the 2d day of the sixth month, the declaration must be filed on or before the 15th day of the sixth month. If, however, the period for which the declaration is filed is one of three months, or one of six months and the requirements of section 58 (a) were not met until after the 1st day of the third month, or one of nine months and such requirements were not met until after the 1st day of the sixth month, the declaration may be filed on or before the 15th day of the succeeding taxable year. For the special rule in the case of farmers, see § 39.60-1 (b)

§ 39.60-3 *Fiscal years.* (a) In the case of a taxpayer on the fiscal year basis, the declaration must be filed on or before the 15th day of the third month of the taxable year. If, however, the requirements of section 58 (a) are first met after the 1st day of the third month and before the 2d day of the sixth month, the declaration must be filed on or before the 15th day of the sixth month of the taxable year. If such requirements are first met after the 1st day of the sixth month, and before the 2d day of the ninth month, the declaration must be filed on or before the 15th day of the ninth month, of the taxable year. If such requirements are first met after the 1st day of the ninth month, the declaration must be filed on or before the 15th day of the first month of the succeeding fiscal year. Thus, if an individual taxpayer is on the fiscal year basis ending June 30, 1953, his declaration must be filed on or before September 15, 1952, if the requirements of section 58 (a) are met on or before September 1, 1952. If, however, such conditions are not met until after September 1, 1952, and before December 2, 1952, the declaration need not be filed until December 15, 1952.

(b) A taxpayer on the fiscal year basis, who first meets the requirements of section 58 (a) after the 1st day of the ninth month of such taxable year, may satisfy the requirements as to the filing of such declaration by filing his return and paying the tax on or before the 15th day of the first month following the close of such fiscal year.

MISCELLANEOUS PROVISIONS

§ 39.61-64 *Statutory provisions; miscellaneous provisions; laws made applicable; rules and regulations; publication of statistics; definitions.*

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, shall be extended to and made a part of this chapter.

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 chapter.

SEC. 63. *Publication of statistics.* The Commissioner, with the approval of the Secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war-profits and excess-profits tax laws, including classifications of taxpayers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable.

SEC. 64. *Definitions.* For definitions of a general character, see section 3797.

SUBPART C—SUPPLEMENTAL PROVISIONS

(CHAPTER I, INTERNAL REVENUE CODE)

SUPPLEMENT A—RATES OF TAX

§ 39.101 *Statutory provisions; exemptions from tax on corporations; in general.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

SEC. 11. *Denial of tax deductions and exemptions [Internal Security Act of 1950].* * * *

(b) No organization shall be entitled to exemption from Federal income tax, under section 101 of the Internal Revenue Code, for any taxable year if at any time during such taxable year (1) such organization is registered under section 7, or (2) there is in effect a final order of the Board [the Subversive Activities Control Board] requiring such organization to register under section 7.

§ 39.101-1 *Proof of exemption; annual returns*—(a) *Proof of exemption in general.* An organization is not exempt from tax merely because it is not organized and operated for profit. In order to establish its exemption, it is necessary that every organization claiming exemption file with the district director of internal revenue for the internal revenue district in which is located the principal place of business or principal office of the organization an application form as set forth below. An organization claiming exemption under section 101 (1), (3) (4) except a bona fide credit union, (6), (7) (8) (9) (10) (12) (14) or (16) shall file the form of application appropriate to its activities, filled out in accordance with the instructions on the form or issued therewith. Copies of the following forms may be obtained from any district director of internal revenue: For organizations claiming exemption under section 101 (6) Form 1023; under section 101 (1), (3) (7) or (8) Form 1024; under section 101 (9) Form 1025; under section 101 (10) (14) or (16) Form 1026; under section 101 (4), except bona fide credit unions, Form 1027; and under section 101 (12) Form 1028. All other organizations claiming exemption, including bona fide credit unions, shall file an application for exemption 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 each such form or application shall be attached a copy of the articles of incorporation, declaration of trust, or other instrument of similar import, setting forth the permitted powers or activities of the organization, the by-laws or other code of regulations, and the latest financial statement showing the assets, liabilities, receipts, and disbursements of the organization. Each such form or application shall contain or be verified by a written declaration that it is made under the penalties of perjury.

(b) *Additional proof by particular classes of organizations.* (1) Organizations mentioned below shall submit with and as a part of their applications the following information:

(i) Mutual insurance companies shall submit copies of the policies or certificates of membership;

(ii) In the case of holding companies claiming exemption under section 101 (14) if the organization for which title is held has not been specifically notified in writing by the Internal Revenue Service that it is held to be exempt under section 101, the holding company shall submit the information indicated herein as necessary for a determination of the status of the organization for which title is held.

(2) In addition to the information specifically called for by this section the Commissioner may require any additional information deemed necessary for a proper determination of whether a particular organization is exempt under section 101, and when deemed advisable in the interest of an efficient administration of the internal revenue laws he may in the cases of particular types of organizations prescribe the form in which the proof of exemption shall be furnished.

(3) An organization claiming to be specifically exempted by section 54 (f) from filing annual returns shall submit with and as a part of its application a statement of all the facts on which it bases its claim.

(c) *Duties of district director with respect to proof of exemption.* The district director of internal revenue, upon receipt of the application and other papers constituting the proof of exemption of an organization claiming exemption from tax under section 101, will forward completed documents to the Commissioner for decision as to whether the organization is exempt.

(d) *"Private shareholder or individual" defined.* The words "private shareholder or individual" in section 101 refer to persons having a personal and private interest in the activities of the organization.

(e) *Requirement of annual returns.* Every organization exempt from tax under section 101, regardless of the amount or source of its income or receipts and irrespective of whether it is chartered by, or affiliated or associated with, any central, parent, or other organization, except organizations specifically exempted from filing annual returns by section 54 (f) (see paragraph (h) of this section) shall file annually with the district director of internal revenue for the internal revenue district in which is located the principal place of business or principal office of the organization a return of information on Form 990 specifically stating the items of gross income, receipts, and disbursements and such other information as may be prescribed by the Commissioner in the instructions on the form or issued by him therewith. However, those organizations which are exempt from tax under section 101 (6) shall, in lieu of using Form 990, file an information return on Form 990-A to comply with the provisions of this section and of § 39.153-1. Returns on Forms 990 and 990-A shall be on the basis of the established annual accounting period of the organization. Where the organization has no such established accounting period, such returns shall be on the basis of the calendar year. Religious and apostolic organizations which are exempt from tax under section 101 (18) shall annually file the return of income required under § 39.101 (18)-1 on the same form (Form 1065) as is required in the case of partnerships, in lieu of Form 990. With respect to group returns, see paragraph (f) of this section. For proof and establishment of right to exemption from tax which must accompany Form 990 or Form 990-A in the case of an organization which has not established its right to such exemption before the filing of the annual return, see paragraphs (a) and (b) of this section.

(f) *Group returns.* A central, parent, or like organization (referred to in this section as central organization) although required to file a separate annual return for itself under section 54 (f) and paragraph (e) of this section, may file annually, in addition to such separate annual return, a group return on Form 990 or Form 990-A as may be appropriate (see paragraph (e) of this section) for two or more of the local organizations, chapters, or the like (referred to in this section as "local organizations") which are (1) chartered by, or affiliated or associated with, such central organization at the close of its annual accounting period, (2) subject to the general supervision of, and examination by, the central organization, and (3) exempt from tax under the same provision of section 101 under which the central organization is exempt from tax. The filing of the group return shall be in lieu of the filing of a separate return by each of the local organizations included in the group return. The group return shall include only those local organizations which in writing have authorized the central organization to include them in the group return, and which have made and filed, with the central organization, their statements, containing written declarations that they are made under the penalties of perjury, specifically stating their items of gross income, receipts, and disbursements, and such other information relating to them which is required to be stated in the group return, and such authorizations and statements shall be permanently retained by the central organization. There shall be attached to the group return and made a part thereof a schedule showing the name and address of each of the local organizations and the total number thereof included in such return, and a schedule showing the name and address of each of the local organizations and the total number thereof not included in the group return. The group return shall be on the basis of the established annual accounting period of the central organization. Where such central organization has no established annual accounting period, such return shall be on the basis of the calendar year. The same income, receipts, and disbursements of a local organization shall not be included in more than one group return. The group return shall be filed in accordance with these regulations and the instructions on Form 990 or Form 990-A or issued therewith, and shall be considered the return of each of the local organizations included therein. For proof and establishment of right to exemption from tax which must accompany Form 990 or Form 990-A in the case of a local organization included in the group return but which has not established its right to such exemption before the filing of the group return, see paragraphs (a) and (b) of this section.

(g) *Date for filing annual returns.* The annual returns of information on Forms 990 and 990-A shall be filed on or before the fifteenth day of the fifth full calendar month following the close of the period for which the return is required to be filed.

(h) *Organizations not required to file annual returns.* (1) Annual returns on Forms 990 and 990-A are not required to be filed by an organization which has established its right to exemption from tax under section 101 (6), if:

(i) It is organized and operated exclusively for religious purposes;

(ii) It is operated, supervised, or controlled by or in connection with an organization which is organized and operated exclusively for religious purposes;

(iii) It is an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly organized body of pupils or students in attendance at the place where its educational activities are regularly carried on; or

(iv) It is a charitable organization, or an organization for the prevention of cruelty to children or animals, which is supported, in whole or in part, by funds contributed by the United States or any State or political subdivision thereof, or which is primarily supported by contributions of the general public.

(2) The annual return on Form 990 need not be filed by a fraternal beneficiary society, order, or association, which has established its exemption from tax solely under section 101 (3), or by an organization exempt from tax under section 101 (15) if it is a corporation wholly owned by the United States or any agency or instrumentality thereof, or is a wholly-owned subsidiary of such a corporation.

(3) An educational organization which normally maintains and has a regular faculty, curriculum, and student body and meets the above conditions which relieve it from the requirement of filing annual returns shall not be considered as having thereafter failed to continue meeting such conditions if it is temporarily compelled to curtail or discontinue its normal and regular activities during the existence of abnormal circumstances and conditions.

(4) An organization organized and operated exclusively for charitable purposes or for the prevention of cruelty to children or animals is not "primarily supported by contributions of the general public" for any accounting period

if more than 50 percent of its income and receipts for such period are not actually derived from voluntary contributions and gifts made by the general public, as distinguished from a few contributors or donors or from related or associated persons. For the purposes of this subparagraph, the words "related or associated persons" refer to persons or a particular group who are connected with or are interested in the activities of the organization such as founders, incorporators, shareholders, members, fiduciaries, officers, employees, or the like, or who are connected with such persons by family or business relationship.

(i) *Records of district directors.* District directors of internal revenue will keep a list of all organizations held to be exempt from tax to the end that they may occasionally inquire into their status and ascertain whether or not they are (1) observing the conditions upon which their exemption is predicated, and (2) annually filing returns on Form 990 or Form 990-A if they are required to file such returns.

(j) *Records, statements, and other returns of tax-exempt organizations.* (1) An organization which has established its right to exemption from tax under section 101 and has also established that it is not required to file annually the return of information on Form 990 or Form 990-A shall immediately notify in writing the district director of internal revenue for the internal revenue district in which is located its principal office of any changes in its character, operations, or purpose for which it was originally created.

(2) Every organization which has established its right to exemption from tax, whether or not it is required to file an annual return of information, shall submit such additional information as may be required by the Commissioner for the purpose of enabling him to inquire further into its exempt status and to administer the provisions of section 54 (f) and this section. For requirement as to keeping of permanent books of account or records, see § 39.54-1.

(3) An organization which has established its right to exemption from tax under section 101, including an organization which is relieved under section 54 (f) and this section from filing returns of income or annual returns of information, is not, however, relieved from the duty of filing other returns of information. See sections 147 and 148.

(k) *Supplement U tax returns.* In addition to the foregoing requirements of this section, certain organizations otherwise exempt from tax under section 101 (1) (6) (7) or (14) which are subject to tax on Supplement U net income, are also required to file returns on Form 990-T. See § 39.421-3 for requirements with respect to such returns.

§ 39.101-2 *Limitations on exemption*—(a) *In general.* Under section 11 (b) of the Internal Security Act of 1950, no organization is entitled to exemption under section 101 for any taxable year if at any time during such year such organization is registered under section 7 of such act or if there is in effect a final order of the Subversive Activities Control Board established by section 12 of such act requiring such organization to register under section 7 of such act. Under sections 3813 and 3814 of the Internal Revenue Code, certain organizations described in section 101 (6) may be denied exemption under section 101 (6). See §§ 39.3813-1 and 39.3814-1.

(b) *Feeder organizations.* (1) In the case of an organization operated for the primary purpose of carrying on a trade or business for profit, exemption is not allowed under any paragraph of section 101 on the ground that all the profits of such organization are payable to one or more organizations exempt from taxation under section 101. For the purpose of this rule, the term "trade or business" does not include the rental by an organization of its real property (including personal property leased with the real property). In determining the primary purpose of an organization, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of those activities of such organization which are specified in the applicable paragraph of section 101. If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization, for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the subsidiary is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.

(2) In certain cases an organization which carries on a trade or business for profit but is not operated for the primary purpose of carrying on such trade or business is subject to tax under Supplement U of chapter 1 of the Internal Revenue Code (which supplement begins with section 421) on its unrelated business net income.

§ 39.101 (1) *Statutory provisions; exemptions from tax on corporations; labor, agricultural, or horticultural organizations.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B), and in supplement U, the following organizations shall be exempt from taxation under this chapter—

(1) Labor, agricultural, or horticultural organizations; * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by sec. 301 (b), Rev. Act 1950; sec. 314 (b), Rev. Act 1951]

§ 39.101 (1)-1. *Labor, agricultural, and horticultural organizations.* (a) 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.

(b) 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 periodic 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. Organizations otherwise exempt from tax under this section are taxable upon their Supplement U net income. See sections 421 to 424, inclusive, and the regulations thereunder.

§ 39.101 (2)-(3) *Statutory provisions; exemptions from tax on corporations; mutual savings banks; fraternal beneficiary societies, orders, or associations.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(2) Mutual savings banks * * * [Repealed by sec. 313 (a), Rev. Act 1951.]

(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; * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by sec. 301 (b), Rev. Act 1950; sec. 314 (b), Rev. Act 1951]

§ 39.101 (3)-1 *Fraternal beneficiary societies.* 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.

§ 39.101 (4) *Statutory provisions; exemptions from tax on corporations; credit unions, etc.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(4) Credit unions without capital stock organized and operated for mutual purposes and without profit; and corporations or associations without capital stock organized prior to September 1, 1951, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of, shares or deposits in—

(A) Domestic building and loan associations,

(B) Cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(C) Mutual savings banks not having capital stock represented by shares; * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by sec. 301 (b), Rev. Act 1950; secs. 313 (b), 314 (b), Rev. Act 1951]

§ 39.101 (4)-1 *Credit unions and mutual insurance funds.* Credit unions (other than Federal credit unions which are exempt under section 101 (15)) without capital stock, organized and operated for mutual purposes and without profit, are exempt from tax under section 101 (4) Corporations or associations without capital stock organized before September 1, 1951, and operated for mutual purposes and without profit for the purpose of providing reserve funds for and insurance of shares or deposits in:

(a) Domestic building and loan associations as defined in section 3797 (a) (19)

(b) Cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(c) Mutual savings banks not having capital stock represented by shares,

are exempt from tax under section 101 (4)

§ 39.101 (5) *Statutory provisions; exemptions from tax on corporations; cemetery companies.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(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; * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by sec. 301 (b), Rev. Act 1950; sec. 314 (b), Rev. Act 1951]

§ 39.101 (5)-1 *Cemetery companies.* (a) 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.

(b) 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 Internal Revenue Code 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.

§ 39.101 (6) *Statutory provisions; exemptions from tax on corporations; religious, charitable, etc., organizations.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(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. For loss of exemption under certain circumstances, see sections 3813 and 3814; * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by secs. 301 (b), 332 (c), Rev. Act 1950; sec. 314 (b), Rev. Act 1951]

§ 39.101 (6)-1 *Religious, charitable, scientific, literary, and educational organizations and community chests.* (a) 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.

(b) 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 volun-

tary contributions from the persons intended to be relieved will not necessarily deprive it of exemption.

(c) An educational organization within the meaning of the Internal Revenue Code 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 Code. 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 forms no substantial part of its activities, its principal purpose and substantially all of its activities being clearly of a nonpartisan, noncontroversial, and educational nature.

(d) Since an organization exempt under section 101 (6) must be organized and operated exclusively for one or more of the specified purposes, an organization organized or operated for the primary purpose of carrying on a trade or business for profit is not exempt thereunder. Thus, such an organization is not exempt under section 101 (6) even though it has certain religious purposes, 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. Organizations, including trusts, otherwise exempt from tax under this section (other than a church, or a convention or association of churches) are taxable on Supplement U net income. See sections 421 to 424, inclusive, and the regulations thereunder.

(e) 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.

(f) Sections 3813 and 3814 set forth rules under which certain organizations described in section 101 (6) may be denied exemption. See §§ 39.3813-1 and 39.3814-1.

§ 39.101 (7) *Statutory provisions; exemptions from tax on corporations; business leagues, etc.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(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; * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this action from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by secs. 301 (b), Rev. Act 1950; sec. 314 (b), Rev. Act 1951]

§ 39.101 (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 Internal Revenue Code and is not exempt from tax. Organizations otherwise exempt from tax under this section are taxable upon their Supplement U net income. See sections 421 to 424, inclusive, and the regulations thereunder.

§ 39.101 (8) *Statutory provisions; exemptions from tax on corporations; civic organizations.*

SEC. 101 *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(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; * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101, as amended by sec. 301 (b), Rev. Act 1950; sec. 314 (b), Rev. Act 1951]

§ 39.101 (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 Internal Revenue Code prescribes as conditions to exemption (a) that the membership of such an association be limited to the employees of a designated person or persons in a particular municipality, and (b) that the net earnings of the association be devoted exclusively to charitable, educational, or recreational purposes. See § 39.101 (6)-1 with reference to the meaning of "charitable" and "educational" and § 39.101 (10)-1 as to the meaning of "local" as used in section 101.

§ 39.101 (9) *Statutory provisions; exemptions from tax on corporations; social clubs.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(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; * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits from payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by sec. 301 (b), Rev. Act 1950; sec. 314 (b), Rev. Act 1951]

§ 39.101 (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, 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.

§ 39.101 (10) *Statutory provisions; exemptions from tax on corporations; benevolent life insurance associations and mutual or cooperative companies.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(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; * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by sec. 301 (b), Rev. Act 1950; sec. 314 (b), Rev. Act 1951]

§ 39.101 (10)-1 *Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.* (a) 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.

(b) 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.

§ 39.101 (11) *Statutory provisions; exemptions from tax on corporations; mutual insurance organizations other than life or marine.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(11) Mutual insurance companies or associations other than life or marine (including interinsurers and reciprocal underwriters) if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000; * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by sec. 165 (a), Rev. Act 1942; sec. 301 (b), Rev. Act 1950; sec. 314 (b), Rev. Act 1951]

§ 39.101 (11)-1 *Mutual insurance companies or associations.* An insurance company is exempt from taxation under chapter 1 of the Internal Revenue Code if it is a mutual company or association (other than life or marine) or an interinsurer or reciprocal underwriter and if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000.

§ 39.101 (12) *Statutory provisions; exemptions from tax on corporations; cooperative farmers' fruit growers' etc., associations.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(12) (A) 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;

(B) An organization exempt from taxation under the provisions of subparagraph (A) shall be subject to the taxes imposed by sections 13 and 15, or section 117 (c) (1), except that in computing the net income of such an organization there shall be allowed as deductions from gross income (in addition to other deductions allowable under section 23)—

(i) Amounts paid as dividends during the taxable year upon its capital stock, and

(ii) Amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. Allocations made after the close of the taxable year and on or before the fifteenth day of the ninth month following the close of such year shall be considered as made on the last day of such taxable year to the extent the allocations are attributable to income derived before the close of such year.

Patronage dividends, refunds, and rebates to patrons with respect to their patronage in the same or preceding years (whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount of such dividend, refund, or rebate) shall be taken into account in computing net income in the same manner as in the case of a cooperative organization not exempt under subparagraph (A). Such dividends, refunds, and rebates made after the close of the taxable year and on or before the 15th day of the ninth month following the close of such year shall be considered as made on the last day of such taxable year to the extent that dividends, refunds, or rebates, are attributable to patronage occurring before the close of such year. * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in

this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by sec. 301 (b), Rev. Act 1950; sec. 314 (a) (b), Rev. Act 1951]

§ 39.101 (12)-1 *Farmers' cooperative marketing and purchasing associations; requirements for exemption under section 101 (12) (A)* (a) (1) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, livestock 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. 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 Internal Revenue Code and is not exempt. In other words, nonmember patrons must be treated the same as members insofar 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 Code 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 Code 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 Code 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.

(2) An association which has capital stock will not for such reason be denied exemption (i) 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 (ii) 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 installation 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 paragraph (a) of this section 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 paragraph (a) or (b) of this section 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 paragraph (a) of this section. 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 Internal Revenue Code. 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 section. 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.

§ 39.101 (12)-2 *Tax treatment of farmers' cooperative marketing and purchasing associations exempt under section 101 (12) (A)*—(a) *In general.* (1) Section 101 (12) (B) is applicable to farmers', fruit growers' or like associations organized and operated on a cooperative basis in the manner prescribed in section 101 (12) (A) Although such an association is subject to both normal tax and surtax, as in the case of corporations generally, certain special rules for the computation of net income are provided in section 101 (12) (B) and § 39.101 (12)-3. For the purpose of any law which refers to organizations exempt from income taxes such an association shall, however, be considered as an organization exempt under section 101. Thus, under section 454 (a) such an association is not subject to the excess profits tax. Similarly, the provisions of section 26 (b) providing a credit for dividends received from a domestic corporation subject to taxation, are not applicable to dividends received from a cooperative association subject to section 101 (12) (B). The provisions of section 141, relating to consolidated returns, are likewise not applicable.

(2) Rules governing the manner in which amounts allocated as patronage dividends, refunds, or rebates are to be taken into account in computing the net income of such an association are set forth in § 39.101 (12)-4. For the tax treatment, as to patrons, of amounts received during the taxable year as patronage dividends, rebates, or refunds, see § 39.22 (a)-23.

(b) *Meaning of terms.* For purposes of §§ 39.101 (12)-2 to 39.101 (12)-4, inclusive, §§ 39.148 (f)-1, and 39.22 (a)-23, the following terms shall have the meaning ascribed below:

(1) *Cooperative association.* The term "cooperative association" includes any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of the business done with or for such patrons, except that the term does not include any cooperative or nonprofit corporation (including any cooperative or nonprofit corporation engaged in rural electrification) exempt from taxation under section 101 (10) or (11) or any corporation subject to a tax imposed by Supplement G (relating to insurance companies)

(2) *Patron.* The term "patron" includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company corporation, or cooperative association.

(3) *Allocation.* The term "allocation" includes distributions made by a cooperative association to a patron in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, similar documents, or in any other manner whereby there is disclosed to a patron the dollar amount apportioned on the books of the association for the account of such patron. Thus, a mere credit to the account of a patron on the books of the cooperative associations, without disclosure to the patron, is not an allocation.

(4) *Patronage dividends, rebates, and refunds.* The term "patronage dividend, rebate, or refund" includes any amount allocated by a cooperative association, to the account of a patron on the basis of the business done with or for such patron. The following are not patronage dividends, rebates, or refunds:

(i) Amounts distributed in redemption of capital stock, or in redemption or satisfaction of certificates of indebtedness, revolving fund certificates, retain certificates, letters of advice, or other similar documents;

(ii) Amounts allocated (whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the amount of such dividend, refund, or rebate) by the association for products of members or other patrons to the extent such amounts are fixed without reference to the earnings of the cooperative association. For this purpose, the term "earnings" includes the excess of amounts retained (or assessed) by the association to cover expenses or other items over the amount of such expenses or other items.

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

Example (1). Cooperative A, a marketing association operating on a pooling basis, receives the products of patron W on January 5, 1952. On the same day Cooperative A advances to W 45 cents per unit for the products so delivered and allocates to him a "retain certificate" having a face value calculated at the rate of 5 cents per unit. During the operation of the pool, and before substantially all the products in the pool are disposed of, Cooperative A advances to W an additional 40 cents per unit, the amount being determined by reference to the market price of the products sold and the anticipated price of the unsold products. At the close of the pool on November 10, 1952, Cooperative A determines the excess of its receipts over the sum of its expenses and its previous advances to patrons, and allocates to W an additional 3 cents per unit and shares of the capital stock of A having an aggregate of face value calculated at the rate of 2 cents per unit.

The amount of patronage dividends, rebates, or refunds allocated to W during 1952 amount to 5 cents per unit, consisting of the aggregate of the following per-unit allocations: The amount of cash distribution (3 cents), and the face value of the capital stock of A (2 cents), which are fixed with reference to the earnings of A. The amount of the two distributions in cash (85 cents) and the face amount of the "retain certificate" (5 cents), which are fixed without reference to the earnings of A, do not constitute patronage dividends, rebates, or refunds.

Example (2). Cooperative B, a marketing association operating on a pooling basis, receives the products of patron X on March 5, 1952. On the same day Cooperative B pays to X $1.00 per unit for such products, this amount being determined by reference to the market price of the product when received, and issues to him a participation certificate having no face value but which entitles X on the close of the pool to the proceeds derived from the sale of his products less the previous payment of $1.00 and the expenses and other charges attributable to such products. On March 5, 1955, Cooperative B, having sold the products in the pool, having deducted the previous payments for such products, and having determined the expenses and other charges of the pool, redeems the participation certificate of X in cash for 10 cents per unit. The allocation made to X during 1955, amounting to 10 cents per unit, is a patronage dividend, rebate, or refund. Neither the payment to X in 1952 of $1.00 nor the issuance to him of the participation certificate in that year constitutes a patronage dividend, rebate, or refund within the meaning of this section.

Example (3). Cooperative C, a purchasing association, obtains supplies for patron Y on May 1, 1952, and receives in return therefor $100. On February 1, 1953, Cooperative C, having determined the excess of its receipts over its costs and expenses, allocates to Y a cash distribution of $1.00 and a revolving fund certificate of a face amount of $1.00. The amount of patronage dividends, rebates, or refunds allocated to Y for 1953 is $2.00, the aggregate of the cash distribution of $1.00, and the face amount, $1.00, of the revolving fund certificate.

Example (4). Cooperative D, a service association, sells the products of members on a fee basis. It receives the products of patron Z under an agreement not to pool his products with those of other members, to sell his products, and to deliver to him the proceeds of the sale. Patron Z makes payments to Cooperative D during 1952 aggregating $75 for service rendered him by Cooperative D during that year. On May 15, 1953, Cooperative D, having determined the excess of its receipts over its costs and expenses, allocates to Z a cash distribution of $2.00. Such amount is a patronage dividend, rebate, or refund allocated by Cooperative D during 1953.

§ 39.101 (12)-3 *Manner of taxation of cooperative associations subject to 101 (12)*—(a) *In general.* Farmers' fruit growers' or like associations, organized and operated in compliance with the requirements of section 101 (12) (A) and § 39.101 (12)-1 shall be subject to the taxes imposed by sections 13 and 15 or section 117 (c) (1) except that there shall be allowed as deductions from gross income, in addition to the other deductions allowable under section 23, certain special deductions provided in section 101 (12) (B) (i) and paragraph (c) of this section, and section 101 (12) (B) (ii) and paragraph (d) of this section. Amounts allocated as patronage dividends, refunds, or rebates, whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated, with respect to patronage for the taxable year or for preceding taxable years, shall be taken into account in the manner provided in section 101 (12) (B) and in § 39.101 (12)-4.

(b) *Cooperative associations exempt from tax before January 1, 1952.* (1) In the case of a cooperative association exempt from tax for taxable years beginning prior to January 1, 1952, the taxable year (fiscal year or calendar year, as the case may be) shall be determined without regard to the fact that such association may have been exempt from tax and not subject to the provisions of section 101 (12) (B) during any prior period. See sections 41 and 48 and the regulations thereunder. Similarly in computing net income, the determination of the taxable year for which an item of income or expense is taken into account shall be made under the provisions of sections 41, 42 and 43 and the regulations prescribed thereunder, whether or not the item arose during a taxable year beginning before, on, or after December 31, 1951. For the purpose of determining the method of accounting of the cooperative association under section 41, a method of accounting recognized under section 41 and under the regulations prescribed thereunder and utilized in the return of such association filed for the first taxable year beginning after December 31, 1951, shall be deemed to constitute the method of accounting regularly employed by the cooperative association. The method selected shall be subject to the approval of the Commissioner upon the examination of the return. Any change of the method so selected and so approved may be made only if permission is obtained from the Commissioner to change to another recognized basis in accordance with § 39.41-2.

(2) In any case where inventories are an income-producing factor see section 22 (c) and (d) and the regulations prescribed thereunder. The elective method of inventorying goods provided in section 22 (d) may be adopted by the cooperative association for any taxable year beginning after December 31, 1951, in accordance with the requirements of section 22 (d) and the regulations issued under that section. In order to use such method for such a taxable year, the cooperative association must exercise the election provided in sections 22 (d) (2) and § 39.22 (d)-3 even though

it may have utilized such method for accounting purposes for taxable years beginning prior to January 1, 1952.

(3) The following rules shall be applicable in computing, under section 122, the net operating loss deduction provided in section 23 (s) No net operating loss carry-back or carry-over shall be allowed from a taxable year beginning prior to January 1, 1952, for which the cooperative association was exempt from tax under section 101 (12) In the case of a taxable year beginning prior to January 1, 1952, for which the association was not exempt under section 101 (12), and of a taxable year beginning after December 31, 1951, the amount of the net operating loss carry-back or carry-over from such year shall not be reduced by reference to the income of any taxable year beginning prior to January 1, 1952, for which the association was exempt from tax under section 101 (12) However, in determining preceding taxable years and succeeding taxable years under section 122 (b) a taxable year beginning prior to January 1, 1952, for which the cooperative association was exempt from tax under section 101 (12) shall be taken into account and shall be considered to be a "preceding taxable year" or a "succeeding taxable year," as the case may be.

(4) The adjustments to the cost or other basis provided in section 113 (b) and §§ 39.113 (b) (1)-1 to 39.113 (b) (1)-3, inclusive, are applicable for the entire period since the acquisition of the property. Thus, proper adjustment to basis must be made under section 113 (b) for depreciation, obsolescence, amortization and depletion for all taxable years beginning prior to January 1, 1952, although the cooperative association was exempt from tax under section 101 (12) for such years. However, the provisions of section 114 (b) (relating to percentage and discovery depletion) are applicable only for such years during which the association was not exempt from tax under section 101 (12) The amendment to section 113 (b) (1) (B) (limiting the adjustment to basis for excessive depreciation, etc., which did not result in a reduction of taxes) made by Public Law 539, 82d Congress, is also applicable for such years where the association has made a proper election in accordance with section 113 (d) and the regulations prescribed thereunder. Similarly, in the case of tax exempt and partially taxable bonds purchased at a premium and subject to amortization under section 125, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond. (For principles governing the method of computation, see the example in § 39.113 (b) (1)-4 relating to mutual savings banks, building and loan associations, and cooperative banks.) The basis of a fully taxable bond purchased at a premium shall be adjusted from the date of the election to amortize such premium in accordance with the provisions of section 125 except that no adjustment shall be allowable for such portion of the premium attributable to the period prior to the election.

(5) In the case of a mortgage acquired at a premium where the principal of such mortgage is payable in installments, adjustments to the basis for the premium must be made for all taxable years (whether or not the association was exempt from tax under section 101 (12) during such years) in which installment payments are received. Such adjustments may be made on an individual mortgage basis or on a composite basis by reference to the average period of payments of the mortgage loans of such association. For the purpose of this adjustment, the term "premium" includes the excess of the acquisition value of the mortgage over its maturity value. The acquisition value of the mortgage is the cost including buying commissions, attorneys' fees or brokerage fees, but such value does not include amounts paid for accrued interest.

(6) The cooperative association may select either of the alternative methods for treating bad debts provided in § 39.23 (k)-1 (a) in the return for its first taxable year beginning after December 31, 1951. The method selected shall be subject to the approval of the Commissioner upon examination of the return. Any change in the method so selected and approved may be made only if permission is granted as provided in § 39.23 (k)-1 (a).

(c) *Deduction for dividends paid.* There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 101 (12) (A) and § 39.101 (12)-1, amounts paid as dividends during the taxable year upon the capital stock of the cooperative association. For the purpose of the preceding sentence, the term "capital stock" includes common stock (whether voting or nonvoting) preferred stock, or any other form of capital represented by capital retain certificates, revolving fund certificates, letters of advice, or other evidence of a proprietary interest in a cooperative association. Such deduction is applicable only to the taxable year in which the dividends are actually or constructively paid to the holder of capital stock or other proprietary interest of the cooperative association. If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mail, 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 such holder within the taxable year, a presumption arises that the dividend was paid to such holder in such year. The determination of whether a dividend has been paid to such holder 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. For further rules as to the determination of the right to a deduction for dividends paid, under certain specific circumstances, see § 39.27 (b)-2.

(d) *Deduction for amounts allocated from income not derived from patronage.* There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 101 (12) (A) and § 39.101 (12)-1 amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether such amounts are paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. For this purpose, allocations made after the close of the taxable year and on or before the 15th day of the ninth month following the close of the taxable year shall be considered as made on the last day of such taxable year to the extent that such allocations are attributable to income derived during the taxable year or during years prior to the taxable year. As used in this paragraph, the term "income not derived from patronage" means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, from the sale or exchange of capital assets, constitutes income not derived from patronage. Business done with the United States shall constitute income not derived from patronage. In order that the deduction for income not derived from patronage may be applicable, it is necessary that the amount sought to be deducted be allocated on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. Thus, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during the taxable year, income realized from such gains must be allocated to patrons of such year in proportion to the amount of business done by such patrons during the taxable year. Similarly, if capital gains are realized by the association from the sale or exchange of capital assets held for a period of more than one taxable year income realized from such gains must be allocated, in proportion insofar as is practicable, to the patrons of the taxable years during which the asset was owned by the association, and to the amount of business done by such patrons during such taxable years.

§ 39.101 (12)-4 *Patronage dividends, rebates, or refunds; treatment as to cooperative associations entitled to tax treatment under section 101 (12) (B)*—(a) *General rule.* Patronage dividends, refunds, or rebates, allocated by a cooperative association entitled to tax treatment under section 101 (12) (B) to a patron shall be taken into account in computing the gross income of such association for the taxable year, as an increase in its other cost of goods sold in the case of an association marketing

products for patrons, or as a reduction in its gross receipts, in the case of an association purchasing supplies and equipment or performing services for patrons, as the case may be, if:

(1) The allocation is made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated, and

(2) The allocation is made on or before the 15th day of the ninth month following the close of the taxable year in which the amounts allocated were received by the cooperative association.

For the purpose of subparagraph (1) of this paragraph, amounts allocated by a cooperative association entitled to tax treatment under section 101 (12) (B) will be deemed allocated in fulfillment and satisfaction of a valid enforceable obligation, if made pursuant to provisions of the by-laws, articles of incorporation, or other contract, whereby the association is obligated to make such allocation after the retention of "reasonable reserves" and after payment of dividends on capital stock or other proprietary capital interests. Notwithstanding the provisions of subparagraphs (1) and (2) of this paragraph, amounts allocated as patronage dividends, refunds, or rebates during the taxable year, or on or before the 15th day of the ninth month following the close of such year, with respect to patronage for years preceding the taxable year, shall be taken into account as an increase in its other cost of goods sold, or as a reduction in gross receipts, for the taxable year, as the case may be, where retention as "reasonable reserves" of the amounts so allocated beyond the year in which earned was proper in accordance with the provisions of section 101 (12) (A) and where the allocation is made to the patron on a patronage basis in proportion insofar as is practicable, to the amount of business done by such patrons during the taxable year or years in which the retained amounts were received by the cooperative association.

(b) *Illustrations.*

Example (1). E, a cooperative association entitled to tax treatment under section 101 (12) (B), organized without capital stock, is engaged in the business of marketing products for its patrons on a non-pool basis. The by-laws of cooperative E provide that there shall be allocated to patrons as patronage dividends within a reasonable time following the close of the year all of the gross returns from sales, less expenses of operation for the year and amounts retained as "reasonable reserves" necessary to the operation of cooperative E. At the close of the taxable year, 1952, it is determined that from the gross returns from sales less operating expenses and all taxes for such year, $5,000 is to be retained as "reasonable reserves" for various necessary purposes of cooperative E. It is assumed that the retention of such amount is proper in accordance with the provisions of section 101 (12) (A). Such $5,000 is apportioned on the books of cooperative E to patrons of 1952 on a patronage basis, or permanent records are kept from which an apportionment to such patrons can be made. On March 1, 1953, pursuant to the terms of the by-laws $200,000, the balance of the gross returns for the taxable year is allocated to patrons of 1952 on the basis of patronage. $100,000 of such $200,000 is allocated in cash. The remaining $100,000 is allocated in "retain certificates" bearing no interest and redeemable in the discretion of the Board of Directors of cooperative E.

There may be added to the cost of goods sold by cooperative E for 1952, $200,000 ($100,000 in cash, $100,000 in retain certificates), the total amount allocated as patronage dividends, rebates or refunds in fulfillment and satisfaction of the obligation of the by-laws, on March 1, 1953, before the 15th day of the ninth month following the close of 1952. There may not be added to the cost of goods sold by cooperative E for 1952, $5,000, the amount retained as reserves apportioned on the books, but not allocated as patronage dividends, rebates, or refunds.

Example (2). The facts are the same as Example 1, it additionally appearing that at the close of 1953 it is determined by Cooperative E to allocate as cash patronage dividends, rebates, or refunds to patrons of 1952, $5,000, the amount retained as "reasonable reserves" for 1952 in accordance with the provisions of section 101 (12) (A). On March 1, 1954, such amount is allocated.

There may be added to the cost of goods sold by Cooperative E for 1953, $5,000, the amount allocated with respect to patronage of a preceding year, 1952, properly maintained as a reserve under section 101 (12) (A).

§ 39.101 (13) *Statutory provisions; exemptions from tax on corporations; corporations organized to finance crop operations.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(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; * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by sec. 301 (b), Rev. Act 1950; sec. 314 (b), Rev. Act 1951]

§ 39.101 (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 § 39.101 (12)-1 relating to a reserve or surplus and to capital stock shall also apply to corporations coming under this section.

§ 39.101 (14) *Statutory provisions; exemptions from tax on corporations; corporations organized to hold title to property for exempt organizations.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(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 chapter;

* * * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by sec. 314 (b), Rev. Act 1951]

§ 39.101 (14)-1 *Corporations organized to hold title to property for exempt organizations.* (a) A corporation otherwise exempt from tax under section 101 (14) is taxable upon its Supplement U net income if the income is payable to an organization which is itself subject to the tax imposed by Supplement U or if the income is payable to a church or to a convention or association of churches. See sections 421 to 424, inclusive, and the regulations thereunder. Since a corporation to be exempt under section 101 (14) must not engage in any business other than that of holding title to property and collecting income therefrom, it cannot have unrelated business net income as defined in section 422 (a) other than Supplement U rental income described in section 423.

(b) A corporation exempt under section 101 (14) cannot accumulate income and retain its exemption, but it must turn over the entire amount of such income, less expenses, to an organization

which is itself exempt from tax under chapter 1 of the Internal Revenue Code.

§ 39.101 (15)–(18) *Statutory provisions; exemptions from tax on corporations; instrumentalities of the United States; employees' beneficiary associations; teachers' retirement fund associations; religious or apostolic organizations.*

SEC. 101 *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—* * *

(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 and amounts contributed to the association by the employer of the 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 investment;

(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. * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by sec. 137 (a), Rev. Act 1942; sec. 301 (b), Rev. Act 1950; sec. 314 (b), Rev. Act 1951]

§ 39.101 (18)–1 *Religious or apostolic associations or corporations.* (a) Religious or apostolic associations or corporations are exempt from taxation under chapter 1 of the Internal Revenue Code 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.

(b) Every association or corporation claiming exemption as a religious or apostolic association or corporation under the provisions of section 101 (18) and this section shall make for each taxable year a return on Form 1065 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.

§ 39.101 (19) *Statutory provisions; exemptions from tax on corporations; employees' beneficiary associations.*

SEC. 101. *Exemptions from tax on corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—

* * * * *

(19) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or their designated beneficiaries, if (A) admission to membership in such association is limited to individuals who are officers or employees of the United States Government, and (B) no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 101 as amended by sec. 217 (a), Rev. Act 1939; sec. 301 (b), Rev. Act 1950; sec. 314 (b), Rev. Act 1951]

§ 39.102 *Statutory provisions; surtax on corporations improperly accumulating surplus.*

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 chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 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:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

38½ 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 chapter—

(1) *Section 102 net income.* The term "section 102 net income" means the net income, computed without the benefit of the capital loss carry-over provided in section 117 (e) from a taxable year which begins after December 31, 1940, and computed without the net operating loss deduction provided in section 23 (s), minus the sum of—

(A) *Taxes.* Federal income, war-profits, and excess-profits taxes (other than the tax imposed by Subchapter E of Chapter 2 for a taxable year beginning after December 31, 1940) 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. For the purposes of the preceding sentence, payment of any contribution or gift shall be considered as made within the taxable year if and only if it is considered for the purposes of section 23 (q) as made within such year.

(C) *Disallowed losses.* Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(D) *Long-term capital gains.* The excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes imposed by this chapter attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between (i) the taxes imposed by this chapter (except the tax imposed by this section) for such year and (ii) such taxes computed for such year without including such excess in net income.

(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), re-

lating 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 section 500.

(f) *Income not placed on annual basis.* Section 47 (c) shall not apply in the computation of the tax imposed by this section.

[Sec. 102 as amended by sec. 211 (f), Rev. Act 1939; secs. 103 (d), 135 (b), 202 (b), Rev. Act 1941; secs. 105 (e), 138, Rev. Act 1942; sec. 122 (g) (5), Rev. Act 1945; sec. 3 (b), Pub. Law 378 (81st Cong.); sec. 315 (a), Rev. Act 1951]

§ 39.102-1 *Taxation of corporation formed or utilized for avoidance of surtax.* (a) Section 102 imposes (in addition to other taxes imposed by chapter 1 of the Internal Revenue Code) 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 section 501, and foreign personal holding companies, as defined in Supplement P (see section 331) 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.

(b) 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) would not be subject to surtax with respect to distributions of the corporation if made.

(c) For the computation of the surtax, see § 39.102-4.

§ 39.102-2 *Purpose to avoid surtax; evidence; burden of proof; definition of holding or investment company.* (a) 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 Internal Revenue Code, 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 nor 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.

(b) 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 Internal Revenue Code 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 Code 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.

(c) 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.

§ 39.102-3 *Unreasonable accumulation of profits.* (a) 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.

(b) 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 in 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.

(c) The Commissioner, or any district director of internal revenue 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)

§ 39.102-4 *Computation of undistributed section 102 net income.* (a) 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) computed without the benefit of the capital loss carry-over provided in section 117 (e) and without the net operating loss deduction provided in section 23 (s) the sum of (1) 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; (2) contributions or gifts payment of which is made within the taxable year (or considered for the purposes of section 23 (q) as made within such year) not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o) and § 39.23 (o)-1 for the purposes therein specified; (3) losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d) for the taxable year; (4) the amount remaining after deducting from the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (computed without regard to any capital loss carry-over) the taxes attributable to such excess. For purposes of this subparagraph, the taxes attributable to such excess shall be the amount remaining after deducting from the taxes imposed by chapter 1 for such year (determined without regard to the taxes imposed by section 102) the taxes similarly imposed and determined for such year without including the excess of net long-term capital gain over the net short-term capital loss for such year in net income. For example, if the taxpayer pays the alternative tax as computed under section 117 (c) the tax attributable to the excess of the net long-term capital gain over the net short-term capital loss shall be the amount computed under section 117 (c) (1) (B) 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 subparagraphs (1) (2) (3), and (4) of this paragraph. 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 subparagraphs (1) (2) (3) and (4) of this paragraph, or any other deductions. See section 233. In the case of a taxable year of less than 12 months on account of a change in the accounting period of the corporation, the corporate net income is computed on the basis of the period included in the taxable year, and is not placed on an annual basis under the provisions of section 47 (c)

(b) 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.

(c) In determining "section 102 net income," section 117 (k) (2) in the case of coal, shall have no application. See § 39.117 (k)-1 (c).

(d) The "undistributed section 102 net income" is computed by subtracting from the "section 102 net income" 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.

§ 39.103-104 *Statutory provisions; tax on citizens and corporations of certain foreign countries; banks and trust companies.*

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 (a), 204 (a), 207, 211 (a), 231 (a), 362, and 400 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 sections 11, 12, 13, 14, 201 (a), 204 (a), 207, 211 (a), 231 (a), 362, and 400, 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. 103 as amended by secs. 163 (b) (1), 172 (c), Rev. Act 1942; sec. 6 (b) (3), Individual Income Tax Act 1944]

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, 38 Stat. 262 (U. S. C., Title 12, section 248k), as amended, and which is subject by law to supervision and examination by State, Territorial or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

(b) *Rate of tax.* Banks shall be subject to tax under section 13 or section 14 (b), and under section 15.

[Sec. 104 as amended by sec. 202, Rev. Act 1939; sec. 104 (c), Rev. Act 1941; sec. 313 (h), Rev. Act 1951]

§ 39.104-1 *Tax on banks.* A bank, as defined in section 104 (a) is, under section 104 (b) subject to the normal tax on corporations imposed by section 13 (see § 39.13-1) and the surtax on corporations imposed by section 15 (see § 39.15-1)

§ 39.104-2 *Mutual savings banks, building and loan associations, and cooperative banks.* (a) Mutual savings banks, building and loan associations, and cooperative banks not having capital stock represented by shares are subject to both normal tax and surtax as in the case of other corporations. Such institutions are, however, not subject to excess profits tax. For special rules governing the taxation of a mutual savings bank conducting a life insurance business, see section 110 and the regulations prescribed thereunder.

(b) While the general principles for determining the net income of a corporation are applicable to a mutual savings bank, a building and loan association, or a cooperative bank not having capital stock represented by shares, there are certain exceptions and special rules governing the computation in the case of such institutions. See § 39.23 (k)-5 for special rules concerning additions to reserves for bad debts. See also § 39.23

(r)–1, relating to dividends paid by banking corporations, for special rules concerning deductions for amounts paid to, or credited to the accounts of, depositors or holders of withdrawable accounts as dividends. Furthermore, in determining the normal tax net income of such an institution, the credit for dividends received provided in section 26 (b) shall not be applicable to dividends which were deductible in computing the net income of the distributing corporation under section 23 (r)

(c) The taxable year (fiscal year or calendar year, as the case may be) of a mutual savings bank, a building and loan association, or a cooperative bank not having capital stock represented by shares shall be determined without regard to the fact that the taxpayer may have been exempt from tax during any prior period. See sections 41 and 48 and the regulations thereunder. Similarly, in computing net income, the determination of the taxable year for which an item of income or expense is taken into account shall be made under the provisions of sections 41, 42, and 43, and the regulations thereunder, whether or not the item arose during a taxable year beginning before, on, or after December 31, 1951. For the purpose of determining, under section 41, the method of accounting of the mutual savings bank, the building and loan association, or the cooperative bank, a method of accounting recognized under section 41 and under the regulations prescribed thereunder and utilized in the return of such institution filed for the first taxable year beginning after December 31, 1951, shall be deemed to constitute the method of accounting regularly employed by the institution. The method selected shall be subject to the approval of the Commissioner upon the examination of the return. Any change in the method so selected and so approved may be made only if permission is obtained from the Commissioner under § 39.41–2 to change to another recognized method. For the purpose of computing, under section 122, the net operating loss deduction provided in section 23 (s) the terms "preceding taxable year" and "preceding taxable years" as used in section 122, shall not include any taxable year for which the institution was exempt from tax. Thus, if the institution was exempt from tax for the immediately preceding taxable year, the net operating loss is not a carry-back to any preceding taxable year, and the net operating loss carry-over to succeeding taxable years is not reduced by the net income for any preceding taxable year. No net operating loss carry-back or carry-over shall be allowed from a taxable year beginning before January 1, 1952.

§ 39.105 *Statutory provisions; sale of oil or gas properties.*

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.

§ 39.105–1 *Surtax on sale of oil or gas properties.* (a) 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 section, 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.

(b) 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.

§ 39.106 *Statutory provisions; claims against United States involving acquisition of property.*

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.

§ 39.106–1 *Surtax on certain amounts received from the United States.* The method of computation provided for in § 39.105–1, 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.

§ 39.107 *Statutory provisions; compensation for services rendered for a period of 36 months or more and back pay.*

SEC. 107. *Compensation for services rendered for a period of thirty-six months or more and back pay*—(a) *Personal services.* If at least 80 per centum of the total compensation for personal services covering a period of thirty-six calendar months or more (from the beginning to the completion of such services) is received or accrued in one taxable year by an individual or a partnership, the tax attributable to any part thereof which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt or accrual.

(b) *Patent, copyright, etc.* For the purposes of this subsection, the term "artistic work or invention" in the case of an individual, means a literary, musical, or artistic composition of such individual or a patent or copyright covering an invention of or a literary, musical, or artistic composition of such individual, the work on which by such individual covered a period of thirty-six calendar months or more from the beginning to the completion of such composition or invention. If, in the taxable year, the gross income of any individual from a particular artistic work or invention by him is not less than 80 per centum of the gross income in respect of such artistic work or invention in the taxable year plus the gross income therefrom in previous taxable years and the twelve months immediately succeeding the close of the taxable year, the tax attributable to the part of such gross income of the taxable year which is not taxable as a gain from the sale or exchange of a capital asset held for more than 6 months shall not be greater than the aggregate of the taxes attributable to such part had it been received ratably over that part of the period preceding the close of the taxable year but not more than thirty-six calendar months.

(c) *Fractional parts of a month.* For the purposes of this section 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.

(d) *Back pay*—(1) *In general.* If the amount of the back pay received or accrued by an individual during the taxable year exceeds 15 per centum of the gross income of the individual for such year, the part of the tax attributable to the inclusion of such back pay in gross income for the taxable year shall not be greater than the aggregate of the increases in the taxes which would have resulted from the inclusion of the respective portions of such back pay in gross income for the taxable years to which such portions are respectively attributable, as determined under the regulations prescribed by the Commissioner with the approval of the Secretary.

(2) *Definition of back pay.* For the purposes of this subsection, "back pay" means (A) remuneration, including wages, salaries, retirement pay, and other similar compensation, which is received or accrued during the taxable year by an employee for services performed prior to the taxable year for his em-

ployer and which would have been paid prior to the taxable year except for the intervention of one of the following events: (i) bankruptcy or receivership of the employer; (ii) dispute as to the liability of the employer to pay such remuneration, which is determined after the commencement of court proceedings; (iii) if the employer is the United States, a State, a Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any of the foregoing, lack of funds appropriated to pay such remuneration; or (iv) any other event determined to be similar in nature under regulations prescribed by the Commissioner with the approval of the Secretary; and (B) wages or salaries which are received or accrued during the taxable year by an employee for services performed prior to the taxable year for his employer and which constitute retroactive wage or salary increases ordered, recommended, or approved by any Federal or State agency, and made retroactive to any period prior to the taxable year; and (C) payments which are received or accrued during the taxable year as the result of an alleged violation by an employer of any State or Federal law relating to labor standards or practices; and which are determined under regulations prescribed by the Commissioner with the approval of the Secretary to be attributable to a prior taxable year. Amounts not includible in gross income under this chapter shall not constitute "back pay."

(e) *Tax on self-employment income.* This section shall be applied without regard to and shall not affect, the tax imposed by subchapter E, relating to tax on self-employment income.

[Sec. 107 as added by sec. 220 (a), Rev. Act 1939; amended by sec. 139 (a), Rev. Act 1942; sec. 119, Rev. Act 1943; sec. 208 (d) (5), Social Security Act Amendments 1950]

§ 39.107–1 *Personal services.* (a) Section 107 (a) provides that if at least 80 percent of the total compensation for personal services covering a period of 36 calendar months or more (from the beginning to the completion of such services) is received or accrued in one taxable year by an individual or a partnership, then the tax attributable to any part of such amount which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had such part been included in the gross income of such individual ratably over that part of the period of service which precedes the date of such receipt or accrual. Thus, for example, if an individual who makes his returns on a calendar year basis and on the basis of cash receipts and disbursements commences personal services on February 17, 1949, and completes them on July 1, 1952, and is paid $8,000 for such services on the completion date, he is entitled to the benefits of section 107 (a) provided the $8,000 is at least 80 percent of the total compensation paid or to be paid to such individual for such services; and the tax attributable to the $8,000 received in 1952 and included in the individual's gross income for such year shall not be greater than the tax attributable to such amount, had it been received ratably over the calendar months included in the period from February 17, 1949, to July 1, 1952. However, if such individual receives an additional $5,000 in 1953 for such services, he is not entitled to the benefits of section 107 (a) with respect to either the $8,000 or the $5,000, for the reason that he does not receive in one taxable year at least 80 percent of the total compensation for such services. Also, for example, if an individual who makes his returns on the calendar year basis and on the basis of cash receipts and disbursements commences personal services on March 3, 1950, and completes them on August 22, 1953, and is paid a total compensation of $10,000 for such services on July 5, 1952, he is entitled to the benefits of section 107 (a) and the tax attributable to the $10,000 received in 1952 and included in such individual's gross income for such year shall not be greater than the tax attributable to such amount, had it been received ratably over the calendar months included in the period from March 3, 1950, to July 5, 1952, the date on which the $10,000 was received. However, if such individual receives an additional $7,000 for such services on May 1, 1953, he is not entitled to the benefits of section 107 (a) for the reason that he does not receive in one taxable year at least 80 percent of the total compensation for such services.

(b) It is immaterial when the personal services are rendered provided at least 36 calendar months elapse from the beginning to the completion of the services. For the purposes of this section, a fractional part of a month is to be disregarded unless it amounts to more than half a month, in which case it is to be considered as a month.

(c) It is not necessary, in order for section 107 (a) to be applicable, that the individual who includes in his gross income compensation for such personal services be the person who renders the services. For example, a partner who shares in the compensation for such personal services rendered by the partnership may be entitled to the benefits of section 107 (a) notwithstanding that he took no part in the rendering of such services.

(d) The first step in determining whether the limitation in section 107 (a) relative to the amount of tax is applicable is the computation of the amount of tax in the current taxable year attributable to that part of the compensation which is included in the gross income of the taxpayer for such year. The tax attributable to such compensation is the difference between the tax for such taxable year computed with the inclusion of such compensation in gross income and the tax for such taxable year computed without including such compensation in gross income.

(e) The next step is to compute the tax attributable to such compensation in each of the taxable years (including the current taxable year) within which falls one or more calendar months included in the part of the period of service which precedes the date such compensation is received or accrued, as if the compensation had been received or accrued in equal portions in each of such calendar months. For what constitutes a taxable year, see section 48 (a) The amount of the tax attributable to such compensation in each such taxable year is the difference between the tax for such year computed with the inclusion of an allocable portion of such compensation in gross income and the tax for such year computed without including any part of such compensation in gross income. The portion of the compensation allocable to each such taxable year is an amount equal to the entire amount of such compensation received or accrued in the current taxable year, divided by the entire number of calendar months included within the part of the period of service which precedes the date such compensation is received or accrued, and multiplied by the number of such calendar months falling within the particular taxable year.

(f) The tax for the current taxable year shall be the tax for such year computed without including the compensation for personal services in gross income, plus (1) the amount of tax for such taxable year attributable to such compensation (computed in accordance with paragraph (d) of this section) or (2) the sum of the taxes attributable to such compensation had it been received in equal portions in each of the calendar months included within the part of the period of service which precedes the date such compensation is received or accrued (computed in accordance with paragraph (e) of this section), whichever is the smaller.

(g) The method of allocating compensation for personal services to the taxable years in which falls any of the calendar months included within the part of the period of service which precedes the date such compensation is received may be illustrated by the following examples, in each of which the taxpayer makes his return on the cash receipts and disbursements basis:

Example (1). On November 1, 1952, A, an individual, who makes his income tax returns on a calendar year basis, receives $40,000, the entire compensation for the performance of personal services covering a 40-month period beginning on June 1, 1949, and ending on September 30, 1952. For the purpose of determining whether the aggregate of the taxes attributable to the $40,000 compensation, had it been received in equal portions in each of the calendar months included within the part of the period of service which precedes the date the compensation is received (in this case the entire period of service), is less than the tax attributable to such compensation in the taxable year 1952, $1,000 ($40,000 divided by 40) must be allocated to each of the calendar months included within the period of service. Thus, $7,000 is allocated to 1949, $12,000 to 1950, $12,000 to 1951, and $9,000 to 1952 (the current taxable year).

Example (2). Assume the same facts as in example (1) except that A makes his income tax returns on the basis of the fiscal year July 1 to June 30. The $40,000 is allocated as follows: $1,000 to the taxable year ended June 30, 1949, $12,000 each to the taxable years ended June 30, 1950, June 30, 1951, and June 30, 1952, and $3,000 to the taxable year ending June 30, 1953 (the current taxable year).

Example (3). Assumes the same facts as in example (1) except that A receives the $40,000 on February 1, 1952 (before completion of the services), instead of November 1, 1952. There are 32 calendar months included within the part of the period of

service which precedes the date the compensation is received. Accordingly, $1,250 ($40,000 divided by 32) must be allocated to each of the calendar months included within the period from June 1, 1949, to February 1, 1952. Thus, $8,750 is allocated to 1949, $15,000 to 1950, $15,000 to 1951, and $1,250 to 1952 (the current taxable year).

Example (4). B, an individual, who makes his income tax returns on a calendar year basis, renders personal services covering a 40-month period beginning on May 1, 1949, and ending on August 31, 1952. The total compensation for such services is $74,000, of which $34,000 is paid to B on March 1, 1952, and $40,000 on August 31, 1952. Using the method of allocation illustrated in example (1), the $40,000 payment must be allocated to the 40 calendar months included within the entire period of service. Accordingly, with respect to the $40,000 payment, $8,000 is allocated to 1949, $12,000 to 1950, $12,000 to 1951, and $8,000 to 1952 (the current taxable year). Using the method of allocation illustrated in example (3), the $34,000 payment must be allocated to the 34 calendar months included within the part of the period of service which precedes the date such payment is received (March 1, 1952). Accordingly, with respect to the $34,000 payment, $8,000 is allocated to 1949, $12,000 to 1950, $12,000 to 1951, and $2,000 to 1952 (the current taxable year). The entire compensation of $74,000 will, therefore, be allocated as follows: $16,000 to 1949, $24,000 to 1950, $24,000 to 1951, and $10,000 to 1952 (the current taxable year).

(h) If an individual, in computing his income tax for a particular taxable year, avails himself of the benefits of section 107 with respect to compensation received or accrued in such year for personal services, and in a subsequent taxable year receives or accrues compensation for other personal services, all or a part of the period of which services is the same as the period of the services for which he was compensated in the previous taxable year, then he must, in availing himself of the benefits of section 107 for such subsequent taxable year, take into consideration the fact that he has previously allocated compensation to all or a part of the period of service. For example, an individual commences the performance of personal services for A on January 1, 1947, and completes them on December 31, 1951. On December 31, 1951, he receives $60,000 in full compensation therefor. In his return for the calendar year 1951, he allocates $1,000 to each of the 60 calendar months included within the period of service and determines his income tax under the provisions of section 107 (a) He also commences the performance of personal services for B on January 1, 1949, and completes them on December 31, 1952. On December 31, 1952, he receives $48,000 in full compensation therefor. If he wishes to avail himself of the benefits of section 107 (a) in his return for the calendar year 1952, he must, in allocating $1,000 to each of the 48 calendar months included within the period of service and computing the tax attributable thereto, include in his income for the years 1949, 1950, and 1951, for the purposes of the tentative computation, the amount of $12,000 previously allocated to each of such years in his return for the calendar year 1951.

(i) The provisions of section 107 and of this section shall be applied without regard to, and shall not affect, the tax on self-employment income imposed by section 480.

§ 39.107-2 *Artistic work or invention.* (a) Section 107 (b) provides that if, in the taxable year, the gross income of an individual from an artistic work or invention of such individual covering a period of 36 calendar months or more (from the beginning to the completion thereof) is not less than 80 percent of the sum of the gross income therefrom in the taxable year, and the gross income therefrom in previous taxable years and in the 12 months following the close of the taxable year, then the tax attributable to such gross income in the taxable year shall not be greater than the aggregate of the taxes attributable thereto had it been received ratably over (1) the part of the period of the work which precedes the close of the taxable year, or (2) a period of 36 calendar months, whichever of such periods is the shorter. That part of the gross income from such artistic work or invention which is taxable as a gain from the sale or exchange of a capital asset held for more than six months is excluded from the benefits of section 107 (b) For the purpose of determining the tax which would be attributable to gain on the sale or exchange of an artistic work had such gain been received ratably in any prior taxable year, such gain shall be treated as gain from the sale or exchange of property which is not a capital asset.

(b) For the purposes of this section, the term "artistic work or invention" means a literary, musical, or artistic composition, or a patent or copyright covering an invention or a literary, musical, or artistic composition. Also, for the purposes of this section, a fractional part of a month is to be disregarded unless it amounts to more than half a month, in which case it is to be considered as a month.

(c) The first step in determining whether the limitation in section 107 (b) relative to the amount of tax is applicable is the computation of the amount of tax in the current taxable year attributable to the gross income received or accrued in such year from the artistic work or invention. The tax attributable to such income is the difference between the tax for such taxable year computed with the inclusion in gross income of the gross income from the artistic work or invention and the tax for such taxable year computed without including in gross income the gross income from the artistic work or invention.

(d) The next step is to compute the tax attributable to the gross income from the artistic work or invention in each of the taxable years (including the current taxable year) within which falls one or more of the calendar months included within the part of the period of work which precedes the close of the current taxable year (not, however, exceeding 36 calendar months) as if the gross income from the artistic work or invention had been received or accrued in equal portions in each of such calendar months. For what constitutes a taxable year, see section 48 (a) The amount of tax attributable to gross income in each such taxable year from the artistic work or invention is the difference between the tax for such year computed with the inclusion in gross income of an allocable portion of the gross income from the artistic work or invention and the tax for such year computed without including in gross income any part of the gross income from the artistic work or invention. The portion of the gross income from the artistic work or invention allocable to each such taxable year is an amount equal to the entire amount of the gross income from the artistic work or invention received or accrued in the current taxable year, divided by the entire number (not to exceed 36) of calendar months included within the part of the period of work which precedes the close of the current taxable year, and multiplied by the number of such calendar months falling within the particular taxable year.

(e) The tax for the current taxable year shall be the tax for such year, computed without including in gross income the gross income from the artistic work or invention, plus whichever of the following is the smaller: (1) The amount of tax for such taxable year attributable to the gross income from the artistic work or invention (computed in accordance with paragraph (c) of this section) or (2) the sum of the taxes attributable to the gross income from the artistic work or invention had it been received in equal portions in each of the calendar months (not exceeding 36 calendar months) included within the part of the period of work which precedes the close of the current taxable year (computed in accordance with paragraph (d) of this section)

(f) The method of allocating the gross income from the artistic work or invention to the taxable years in which falls any of the calendar months (not exceeding 36 calendar months) included within the part of the period of work which precedes the close of the current taxable year may be illustrated by the following examples:

Example (1). On October 1, 1952, A, an individual, who makes his returns on a calendar year basis and on the basis of cash receipts and disbursements, receives $36,000 in full payment for a musical composition, the work on which was commenced by A on July 10, 1948, and completed on January 29, 1953. Although the period of work covers 55 calendar months, allocations may be made to only the last 36 calendar months included within the part of the period of work which precedes the close of 1952 (the current taxable year). Therefore, $1,000 ($36,000 divided by 36) must be allocated to each of the 36 calendar months preceding January 1, 1953. Accordingly, $12,000 is allocated to 1950, $12,000 to 1951, and $12,000 to 1952 (the current taxable year).

Example (2). Assume the same facts as in example (1) except that the period of work was commenced by A on July 1, 1951, and completed on September 1, 1954. Although the period of work covers 38 calendar months, allocations may be made to only the 18 calendar months which are included within the part of the period of work which precedes the close of 1952 (the current tax-

able year). Therefore, $2,000 ($36,000 divided by 18) must be allocated to each of 18 calendar months preceding January 1, 1953. Accordingly, $12,000 is allocated to 1951, and $24,000 to 1952 (the current taxable year).

(g) The principles set forth in paragraph (h) of § 39.107-1, relating to the manner of allocating compensation for personal services to a particular calendar month where an allocation for other such services has previously been made to such month, are also applicable with respect to allocations under section 107 (b) and this section.

(h) The provisions of section 107 and of this section shall be applied without regard to, and shall not affect, the tax on self-employment income imposed by section 480.

§ 39.107-3 *Back pay attributable to prior taxable years.* (a) Section 107 (d) (2) defines "back pay" and section 107 (d) (1) limits the amount of tax resulting from the inclusion of such back pay in gross income for the year in which it is received or accrued. Back pay includes compensation, wages, salaries, pensions, and retirement pay received or accrued during the taxable year by an employee for services performed prior to the taxable year for his employer and which would have been paid prior to the taxable year but for the intervention of any one of the following events: (1) bankruptcy or receivership of the employer; (2) dispute as to the liability of the employer to pay such remuneration, which is determined after the commencement of court proceedings; (3) if the employer is the United States, a State, a Territory or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any of the foregoing, lack of funds appropriated to pay such remuneration; or (4) any other event determined to be similar in nature under this section. As to what constitutes bankruptcy and receivership proceedings, see § 39.274-1.

(b) An event will be considered similar in nature to those events specified in section 107 (d) (2) (A) (i) (ii) and (iii) only if the circumstances are unusual, if they are of the type specified therein, if they operate to defer payment of the remuneration for the services performed, and if payment, except for such circumstances, would have been made prior to the taxable year in which received or accrued. For the purposes of this section, the term "back pay" does not include remuneration which is deemed to be constructively received in the taxable year or years in which the services were performed, remuneration paid in the current year in accordance with the usual practice or custom of the employer even though received in respect of services performed in a prior year or years, additional compensation for past services where there was no prior agreement or legal obligation to pay such additional compensation, or any amount which is not includible in gross income under chapter 1 of the Internal Revenue Code. The term "back pay" also embraces retroactive wage or salary increases received or accrued in respect of services performed by an employee for his employer in a prior taxable year which have been ordered, recommended, or approved by any Federal or State agency such as, but not limited to, the Wage Stabilization Board, the Salary Stabilization Board, and boards authorized by the Railway Labor Act (45 U. S. C. 151-188) comparable State organizations, and United States and State courts; payments made as a result of alleged violations of sections 6 and 7 of the Fair Labor Standards Act of 1938 (29 U. S. C. 206, 207) and made retroactive to any period prior to the taxable year; and payments which are received or accrued during the taxable year arising out of an alleged violation by an employer of any State or Federal law relating to labor standards or practices, such as payments received to effectuate the policies of the National Labor Relations Act (29 U. S. C. 151-166)

(c) An individual must compute his net income for any taxable year to which back pay is attributable, even though he was not required to make a return for such year. Thus, all amounts properly includible as gross income for any taxable year to which back pay is attributable must be included in the computation.

(d) For the purpose of determining under section 107 (d) the particular taxable year or years to which the back pay is attributable and, if such back pay is attributable to more than one taxable year, the amount thereof which is attributable to each of such taxable years, the following rules will be applicable:

(1) Back pay, as defined under section 107 (d) (2) (A), shall be deemed to be attributable to a particular taxable year in the amount and to the extent that it would have been paid in such year except for the intervention of one of the events described in section 107 (d) (2) (A)

(2) Back pay, as defined under section 107 (d) (2) (B) shall be deemed to be attributable to a particular taxable year in the amount and to the extent that it would have been paid in such year had the wage or salary increase as described in section 107 (d) (2) (B) been actually put into effect on the date to which it was first made retroactive.

(3) Back pay, as defined under section 107 (d) (2) (C) shall be deemed to be attributable to a particular taxable year in the amount and to the extent that it represents payments in respect of the alleged violation described in section 107 (d) (2) (C) which occurred in such year or which continued during any part of such year.

(4) In those cases where a computation has been made by, or under the direction of, a Federal or State agency (including any Federal or State court) under which the back pay was awarded, which indicates that particular portions of such back pay are attributable to certain definite periods of time, such computation shall be accepted as the appropriate apportionment for the purposes of this section.

(5) Where no computation has been made as provided in subparagraph (4) of this paragraph, and where the apportionment cannot be accurately made upon consideration of all the attendant circumstances in accordance with the applicable rule prescribed in subparagraph (1) (2), or (3) of this paragraph, then in proper cases the back pay shall be apportioned to each of the taxable years within which fall one or more calendar months included within the entire period for which such back pay has been paid, as if such back pay had been received or accrued in equal portions in each of such calendar months. For the purposes of this section, a fractional part of a month is to be disregarded unless it amounts to more than half a month, in which case it is to be considered as a month.

(e) In determining whether section 107 (d) is applicable, the percentage which the back pay is of the gross income of the taxpayer for the current taxable year must be ascertained. It must exceed 15 percent of such gross income.

(f) The amount of the tax attributable to back pay is the difference between the tax for the taxable year computed with the inclusion of such back pay in gross income and the tax for such taxable year computed without including such back pay in such gross income. The amount of the tax attributable to back pay in each taxable year is the difference between the tax for such taxable year computed with the inclusion in gross income of the portion of such back pay attributable to such taxable year and the tax for such taxable year computed without including any part of such back pay in gross income. The tax for the current taxable year is the smaller of (1) the tax computed with the inclusion in gross income of the entire back pay received or accrued in the taxable year, or (2) the tax computed without including any such back pay in gross income for the current taxable year, plus the aggregate of the increase in the taxes which would have resulted from the inclusion of the respective portions of such back pay in gross income for each taxable year to which each such portion is respectively attributable.

(g) This section may be illustrated by the following example in which the taxpayer makes his returns on the cash receipts and disbursements basis, and in which it is assumed that he is entitled to use and uses for the taxable years 1952, 1949, and 1948, the alternative tax provided in Supplement T:

Example. In 1952, a single individual with no dependents who makes his income tax returns on the calendar year basis receives $4,200, which amount constitutes his adjusted gross income. Of this amount, $1,000 constitutes back pay. His tax for the calendar year 1952 on $4,200 would be $740. On $3,200 ($4,200 minus $1,000) the tax would be $518. That part of the tax for 1952 attributable to back pay is therefore $222 ($740 minus $518). Of the back pay, $600 is attributable to the year 1949. During such year he had received $1,700. For such year the amount of tax on $1,700 is $156. The amount of tax which he would have paid for such year had he included in gross income

the portion of back pay attributable to such year would be $246. The increase in the tax for such year would be $90 ($246 minus $156). The remainder of the back pay, $400, is attributable to the calendar year 1948. During such year he had received $1,200. For such year the amount of tax is $82 and the amount of tax which he would have paid for such year had he included in gross income the portion of back pay attributable to such year would be $141. The increase in the tax for such year would be $59 ($141 minus $82). The aggregate of the increases of taxes for the calendar years 1949 and 1948 would be $149. The tax for the calendar year 1952 is the smaller of $518 plus (1) $222 or (2) $149. Since $149 is smaller than $222, the tax for the calendar year 1952 is $667 ($518 plus $149).

(h) The provisions of section 107 and of this section shall be applied without regard to, and shall not affect, the tax on self-employment income imposed by section 480.

§ 39.108 *Statutory provisions; fiscal year taxpayers.*

SEC. 108. *Fiscal year taxpayers.* (a) to (h), inclusive. * * * [applicable only to taxable years beginning before January 1, 1952].

(i) *Definition of calendar month.* For the purposes of this section, a calendar month only part of which falls within a taxable year (1) shall be disregarded if less than 15 days of such month are included in such taxable year, and (2) shall be included as a calendar month within the taxable year if more than 14 days of such month fall within the taxable year.

(j) *Taxable years of individuals beginning in 1953 and ending in 1954.* In the case of a taxable year of a taxpayer, other than a corporation, beginning before January 1, 1954, and ending after December 31, 1953, the tax imposed by sections 11 and 12, section 400, or section 421 (a) (2), shall be an amount equal to the sum of—

(1) That portion of a tentative tax, computed under the provisions of sections 11 and 12, section 400, or section 421 (a) (2), applicable to years beginning on January 1, 1953, which the number of calendar months in such taxable year prior to January 1, 1954, bears to the total number of calendar months in such taxable year, plus

(2) That portion of a tentative tax, computed under the provisions of sections 11 and 12, section 400, or section 421 (a) (2), applicable to years beginning on January 1, 1954, as if such provisions were applicable to such taxable year, which the number of calendar months in such taxable year after December 31, 1953, bears to the total number of calendar months in such taxable year.

(k) *Taxable years of corporations beginning before April 1, 1954, and ending after March 31, 1954.* In the case of a taxable year of a corporation beginning before April 1, 1954, and ending after March 31, 1954, the tax imposed by sections 13 and 15, or section 421 (a) (1), shall be an amount equal to the sum of—

(1) That portion of a tentative tax, computed under the provisions of sections 13 and 15, or section 421 (a) (1), applicable to years beginning on January 1, 1953, which the number of days in such taxable year prior to April 1, 1954, bears to the total number of days in such taxable year, plus

(2) That portion of a tentative tax, computed under the provisions of sections 13 and 15, or section 421 (a) (1), applicable to years beginning on April 1, 1954, as if such provisions were applicable to such taxable year, which the number of days in such taxable year after March 31, 1954, bears to the total number of days in such taxable year.

(l) *Special classes of taxpayers.* This section shall not apply to an insurance company subject to Supplement G or an investment company subject to Supplement Q.

[Sec. 108 as added by sec. 140 (a), Rev. Act 1942; amended by sec. 108, Rev. Act 1943; sec. 131 (a); Rev. Act 1945; sec. 601, Rev. Act 1948; sec. 131 (a), Rev. Act. 1950; sec. 203, Excess Profits Tax Act 1950; sec. 131 (a), (c) (2), Rev. Act 1951]

§ 39.108-1 *Computation of tax of individuals for taxable years beginning in 1953 and ending in 1954*—(a) *General rule.* For a taxable year beginning in 1953 and ending in 1954, the normal tax, surtax, optional tax, and Supplement U normal tax and surtax, imposed by sections 11, 12, 400, and 421 (a) (2) upon taxpayers other than corporations, shall be computed under section 108 (j) The tax shall be an amount equal to the sum of:

(1) That portion of a tentative tax under section 108 (j) (1) computed under the provisions of sections 11 and 12, section 400, or section 421 (a) (2) applicable to taxable years beginning on January 1, 1953, which the number of calendar months before January 1, 1954, in the taxable year of the taxpayer bears to the total number of calendar months in such taxable year, and

(2) That portion of a tentative tax under section 108 (j) (2) computed under the provisions of sections 11 and 12, section 400, or section 421 (a) (2) applicable to taxable years beginning on January 1, 1954, which the number of calendar months after December 31, 1953, in the taxable year of the taxpayer bears to the total number of calendar months in such taxable year.

For the purpose of section 108 (j) and this section, a calendar month only part of which falls within the taxable year (1) shall be disregarded if less than 15 days of such month are included in such taxable year, and (2) shall be included as a calendar month within the taxable year if more than 14 days of such month fall within the taxable year.

(b) *Estates, trusts, and nonresident alien individuals.* The provisions of section 108 (j) apply to estates, trusts, and nonresident alien individuals subject to tax under sections 11 and 12 and to trusts described in section 421 (b) (2) which are subject to tax under section 421 (a) (2)

(c) *Short taxable years.* The provisions of section 108 (j) apply to a taxable year beginning in 1953 and ending in 1954, whether or not such taxable year is one of less than 12 months. In the case of a taxpayer who is subject to the provisions of section 108 (j) and who because of a change in accounting period has a taxable year of less than 12 months, the net income shall be placed on an annual basis under the provisions of section 47 (c) (1) for the purpose of both tentative tax computations under section 108 (j) or shall be computed under the exception in section 47 (c) (2) for the purpose of both such tentative tax computations. Regardless of the method adopted, the amounts of the tentative normal tax and surtax so computed upon the basis of 12 months' income shall be properly reduced under section 47 (c) in order to determine the tentative taxes under section 108 (j). However, in the case of a taxpayer who is subject to the provisions of section 108 (j) and who because of any reason other than a change in accounting period has a taxable year of less than 12 months, the net income shall not be placed on an annual basis under section 47 (c) (1) and shall not be computed under the exception in section 47 (c) (2)

(d) *Alternative tax under section 117 (c)* In any case in which a taxpayer subject to the provisions of section 108 (j) has an excess of net long-term capital gains over net short-term capital losses, the alternative tax under section 117 (c) shall be an amount equal to the sum of the proper portions of the tentative taxes determined under section 108 (j) by computing each such tentative tax pursuant to the alternative tax computation provided in section 117 (c), regardless of whether either tentative tax so computed on the alternative basis is larger or smaller than the tentative tax computed without regard to section 117 (c)

(e) *Certain joint returns.* If a joint return of a husband and wife is filed under the provisions of section 51 (b) (3), if the husband and wife have different taxable years solely because of the death of either spouse, and if the taxable year of the surviving spouse covered by such joint return is a period which begins in 1953 and ends in 1954, the number of calendar months to be taken into account for the purpose of computing the portions of the tentative tax under section 108 (j) (1) and (2) shall be the number of calendar months before January 1, 1954, in the taxable year of the surviving spouse, the number of calendar months after December 31, 1953, in the taxable year of the surviving spouse, and the total number of calendar months in the taxable year of the surviving spouse.

(f) *Credits against tax.* In the case of a taxpayer subject to the provisions of section 108 (j) any credit against the tax otherwise imposed by sections 11, 12, 400, and 421 (a) (2) such as the credit for taxes paid to a foreign country or possession of the United States under section 131, shall be deducted from, and any limitation in such credit shall be based upon, the tax computed under section 108 (j) However, in those instances in which an individual taxpayer computes a tentative tax under section 108 (j) by taking into account the optional standard deduction under section 23 (aa) the following credits shall not be allowed: All credits under section 131 with respect to taxes of foreign countries and possessions, and all credits with respect to taxes withheld at the source under section 143 (a) relating to interest on tax-free covenant bonds.

§ 39.108-2 *Computation of tax of corporations for taxable years beginning before April 1, 1954, and ending after March 31, 1954*—(a) *General rule.* For a taxable year beginning before April 1, 1954, and ending after March 31, 1954 (including the calendar year 1954), the

normal tax, surtax, and Supplement U normal tax and surtax imposed by sections 13, 15, and 421 (a) (1) upon corporations shall be computed under section 108 (k) The tax shall be an amount equal to the sum of:

(1) That portion of a tentative tax under section 108 (k) (1) computed under the provisions of sections 13 (b) (2) and 15 (b) or section 421 (a) (1) applicable to taxable years beginning on January 1, 1953, which the number of days before April 1, 1954, in the taxable year of the taxpayer bears to the total number of days in such taxable year, and

(2) That portion of a tentative tax under section 108 (k) (2) computed under the provisions of sections 13 (b) (3) and 15 (b) or section 421 (a) (1) applicable to taxable years beginning on April 1, 1954, which the number of days after March 31, 1954, in the taxable year of the taxpayer bears to the total number of days in such taxable year.

The tentative normal taxes under section 108 (k) (1) and (2) of a corporation are computed at the rates of 30 percent and 25 percent, respectively, upon its normal-tax net income or upon its Supplement U net income, in the case of a corporation subject to tax under Supplement U. The tentative surtaxes under section 108 (k) (1) and (2) of a corporation are computed upon its corporation surtax net income or Supplement U net income, as the case may be, in excess of $25,000 at the rate of 22 percent. See, however, section 15 (c) and § 39.15-2 as to the circumstances under which the $25,000 exemption from surtax may be disallowed, in whole or in part, in the computation under section 108 (k) (1) of the tentative surtax under section 15 for a taxable year beginning before July 1, 1953.

(b) *Computation of normal-tax net income and corporation surtax net income in special cases*—(1) *In general.* In computing the tentative taxes under section 108 (k) (1) and (2) the amount of the net income and the amount of the adjusted net income of the corporation are not recomputed and remain unchanged. However, the credits provided in section 26 (b) (h) and (i) may differ in computing the several tentative taxes. Thus, in the case of a Western Hemisphere trade corporation, or a public utility corporation which has paid dividends on its preferred stock with respect to which the credit for dividends paid provided in section 26 (h) is allowable, or any corporation which has received dividends on the preferred stock of a domestic public utility corporation with respect to which the credit provided in section 26 (h) is allowable to the distributing corporation, the amount of the normal-tax net income and the amount of the corporation surtax net income for the first tentative tax computation differ from such amounts for the second tentative tax computation. See subparagraphs (2) (3) and (4) of this paragraph.

(2) *Western Hemisphere trade corporations.* In the case of a Western Hemisphere trade corporation, its normal-tax net income and corporation surtax net income are determined, for the purpose of the tentative tax computation under section 108 (k) (1) with the allowance of the 27-percent credit provided in section 26 (i) applicable to a taxable year beginning on January 1, 1953, and, for the purpose of the tentative tax computation under section 108 (k) (2) with the allowance of the 30-percent credit provided in section 26 (i) applicable to a taxable year beginning on April 1, 1954.

(3) *Public utilities paying dividends on preferred stock.* In the case of a public utility corporation which has paid dividends on its preferred stock with respect to which the credit for dividends paid provided in section 26 (h) is allowable, its normal-tax net income and corporation surtax net income are determined, for the purpose of the tentative tax computation under section 108 (k) (1) with the allowance of the 27-percent credit provided in section 26 (h) applicable to a taxable year beginning on January 1, 1953, and, for the purpose of the tentative tax computation under section 108 (k) (2) with the allowance of the 30-percent credit provided in section 26 (h) applicable to a taxable year beginning on April 1, 1954.

(4) *Corporations receiving dividends on preferred stock of public utility.* In the case of any corporation which has received dividends on the preferred stock of a domestic public utility corporation with respect to which the credit provided in section 26 (h) is allowable to the distributing corporation, its normal-tax net income and corporation surtax net income are determined, for the purpose of the tentative tax computation under section 108 (k) (1) with the allowance of the 62-percent credit provided in section 26 (b) (2) with respect to such dividends received, and, for the purpose of the tentative tax computation under section 108 (k) (2) with the allowance of the 59-percent credit provided in section 26 (b) (2) with respect to such dividends received.

(c) *Classes of corporations excluded from operation of section 108 (k).* The provisions of section 108 (k) do not apply to an insurance company subject to Supplement G, a regulated investment company subject to Supplement Q, or a foreign corporation not engaged in trade or business within the United States other than such a corporation subject to Supplement U.

(d) *Short taxable years.* The provisions of section 108 (k) apply to a taxable year beginning before April 1, 1954, and ending after March 31, 1954, whether or not such taxable year is one of less than 12 months. In the case of a taxpayer which is subject to the provisions of section 108 (k) and which because of a change in accounting period has a taxable year of less than 12 months, the net income shall be placed on an annual basis under the provisions of section 47 (c) (1) for the purpose of both tentative tax computations under section 108 (k) or shall be computed under the exception in section 47 (c) (2) for the purpose of both such tentative tax computations. Regardless of the method adopted, the amounts of the tentative normal tax and surtax so computed upon the basis of 12 months' income shall be properly reduced under section 47 (c) in order to determine the tentative taxes under section 108 (k) However, in the case of a taxpayer which is subject to the provisions of section 108 (k) and which because of any reason other than a change in accounting period has a taxable year of less than 12 months, the net income for the purpose of section 108 (k) shall not be placed on an annual basis under section 47 (c) (1) and shall not be computed under the exception in section 47 (c) (2)

(e) *Alternative tax under section 117 (c)* In any case in which a taxpayer subject to the provisions of section 108 (k) has an excess of net long-term capital gains over net short-term capital losses, the alternative tax under section 117 (c) shall be an amount equal to the sum of the proper portions of the tentative taxes determined under section 108 (k), by computing each such tentative tax pursuant to the alternative tax computation provided in section 117 (c) regardless of whether either tentative tax so computed on the alternative basis is larger or smaller than the tentative tax computed without regard to section 117 (c)

(f) *Credits against tax.* In the case of a taxpayer subject to the provisions of section 108 (k) any credit against the tax otherwise imposed by sections 13, 15, and 421 (a) (1) such as the credit for taxes paid to a foreign country or possession of the United States under section 131, shall be deducted from, and any limitation in such credit shall be based upon, the tax computed under section 108 (k).

(g) *Example.* This section may be illustrated by the following example:

Example. The A Corporation, a domestic corporation (which is neither a public utility referred to in section 26 (h) nor a Western Hemisphere trade corporation referred to in section 26 (i), and which is not subject to tax under Supplement U), makes its income tax returns on the basis of the calendar year. For the calendar year 1954, the A Corporation has net income of $100,000, which does not include any interest on United States obligations or dividends on stock of foreign corporations. The net income includes cash dividends received from a domestic corporation other than a public utility (allowable as a credit under section 26 (b) (1)) in the amount of $10,000, and cash dividends received from a domestic public utility corporation on its preferred stock (with respect to which a credit is allowable to the public utility under section 26 (h)) in the amount of $5,000. The normal tax and surtax of the A Corporation for the calendar year 1954 are $23,218.12 and $13,972.88, respectively, computed as follows:

(1) *Computation of tentative taxes provided in section 108 (k) (1)*		
NORMAL TAX AND SURTAX		
1. Net income		$100,000.00
2. Less credit under section 26 (b) (1) for dividends received from domestic corporation other than dividends with respect to which credit is allowable under section 26 (h) (85 percent of $10,000)	$8,500.00	
3. Less credit under section 26 (b) (2) for dividends received with respect to which credit is allowable under section 26 (h) (62 percent of $5,000)	3,100.00	11,600.00
4. Normal-tax net income and corporation surtax net income		88,400.00
5. Normal tax (30 percent of item 4)		26,520.00
6. Surtax (22 percent of $63,400, the excess of $88,400 over $25,000)		13,948.00
(2) *Computation of tentative taxes provided in section 108 (k) (2)*		
NORMAL TAX AND SURTAX		
7. Net income		$100,000.00
8. Less credit under section 26 (b) (1) (85 percent of $10,000)	$8,500.00	
9. Less credit under section 26 (b) (2) (59 percent of $5,000)	2,950.00	11,450.00
10. Normal-tax net income and corporation surtax net income		88,550.00
11. Normal tax (25 percent of item 10)		22,137.50
12. Surtax (22 percent of $63,550, the excess of $88,550 over $25,000)		13,981.00
(3) *Computation of normal tax and surtax for calendar year 1954.*		
13. Number of days in taxable year before Apr. 1, 1954		90
14. Number of days in taxable year after March 31, 1954		275
15. Total number of days in taxable year		365
NORMAL TAX		
16. Tentative normal tax computed in (1)	$26,520.00	
17. 90/365ths of $26,520		$6,539.18
18. Tentative normal tax computed in (2)	22,137.50	
19. 275/365ths of $22,137.50		16,678.94
20. Total normal tax		23,218.12
SURTAX		
21. Tentative surtax computed in (1)	$13,948.00	
22. 90/365ths of $13,948		3,439.23
23. Tentative surtax computed in (2)	13,981.00	
24. 275/365ths of $13,981		10,533.63
25. Total surtax		13,972.86

§ 39.109 *Statutory provisions; Western Hemisphere trade corporations.*

SEC. 109 *Western Hemisphere trade corporations.* For the purposes of this chapter, the term "western hemisphere trade corporation" means a domestic corporation all of whose business is done in any country or countries in North, Central, or South America, or in the West Indies, or in Newfoundland and which satisfies the following conditions:

(a) If 95 per centum or more of the gross income of such domestic corporation for the three-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources other than sources within the United States; and

(b) If 90 per centum or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business.

[Sec. 109 as added by sec. 141, Rev. Act. 1942]

§ 39.109-1 *Western Hemisphere trade corporations.* (a) The term "Western Hemisphere trade corporation" for the purposes of chapter 1 of the Internal Revenue Code means a domestic corporation which meets the following tests:

(1) Its entire business must be carried on within the geographical limits of North, Central, or South America, or in the West Indies, or in Newfoundland; and

(2) 95 percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) must be derived from sources without the United States; and

(3) 90 percent or more of its gross income for such period or such part thereof must be derived from the active conduct of a trade or business.

A domestic corporation is not excluded from the definition merely because, incident to the conduct of its trade or business, it retains title in goods to insure payment for such goods shipped to a country outside the geographical areas enumerated in section 109.

(b) A corporation which claims to qualify as a Western Hemisphere trade corporation shall attach to its income tax return a statement showing that its entire business is done in one or more of the designated countries, and for the three-year period immediately preceding the close of the taxable year (or for such part thereof during which the corporation was in existence) (1) its total gross income from all sources, (2) the amount thereof derived from the active conduct of a trade or business, (3) a description of such trade or business and the facts upon which the corporation relies to establish that such trade or business was actively conducted by it, and (4) the amount of its gross income, if any, from sources within the United States. The gross income from sources without the United States and within the United States shall be determined as provided in section 119 and the regulations prescribed thereunder.

§ 39.110 *Statutory provisions; mutual savings banks conducting life insurance business.*

SEC. 110. *Mutual savings banks conducting life insurance business.*—(a) *Alternative tax.* In the case of a mutual savings bank not having capital stock represented by shares, authorized under State law to engage in the business of issuing life insurance contracts, and which conducts a life insurance business in a separate department the accounts of which are maintained separately from the other accounts of the mutual savings bank, there shall be levied, collected, and paid, in lieu of the taxes imposed by sections 13 and 15, or section 117 (c) (1), a tax consisting of the sum of the partial taxes determined under paragraphs (1) and (2)

(1) A partial tax computed upon the net income determined without regard to any items of gross income or deductions properly allocable to the business of the life insurance department, at the rates and in the manner as if this section has not been enacted; and

(2) a partial tax computed upon the net income (as defined in section 201 (c) (7)) of the life insurance department determined without regard to any item of gross income or deductions not properly allocable to such department, at the rates and in the manner provided in Supplement G with respect to life insurance companies.

(b) *Limitations of section.* The provisions of subsection (a) shall be applicable only if the life insurance department would, if it were treated as a separate corporation, qualify as a life insurance company under section 201 (b).

[Sec. 110 as added by sec. 346 (a), Rev. Act 1951]

§ 39.110-1 *Mutual savings banks conducting life insurance business*—(a) *Scope of application.* Section 110 is applicable in the case of a mutual savings bank not having capital stock represented by shares which conducts a life insurance business, if:

(1) The conduct of the life insurance business is authorized under State law.

(2) The life insurance business is carried on in a separate department of the bank,

(3) The books of account of the life insurance business are maintained separately from other departments of the bank, and

(4) The life insurance department of the bank, were it separately incorporated, would qualify as a life insurance company under section 201 (b)

(b) *Computation of tax.* In the case of a mutual savings bank conducting a life insurance business to which section 110 is applicable, the tax upon such bank consists of the sum of the following:

(1) A partial tax computed under sections 13 and 15 upon the net income of the bank determined without regard to any items of income or deduction properly allocable to the life insurance department.

(2) A partial tax upon the net income of the life insurance department determined without regard to any items of income or deduction not properly allocable to such department at the rates and in the manner provided in Supplement G with respect to life insurance companies.

SUPPLEMENT B—COMPUTATION OF NET INCOME

§ 39.111 *Statutory provisions; determination of amount of, and recognition of, gain or loss.*

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 chapter, 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.

§ 39.111-1 *Computation of gain or loss.* (a) Except as otherwise provided, the Internal Revenue Code 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 §§ 39.113 (b) (1)-1 to 39.113 (b) (4)-1, inclusive (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.

(b) (1) Even though property is not sold or otherwise disposed of, gain 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. Except as otherwise provided in section 115 (b) with respect to distributions out of increase in value of property accrued prior to March 1, 1913, such gain is includible in gross income under section 22 (a) as "gains or profits and income derived from any source whatever." See § 39.115 (d)-1. 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 Internal Revenue Code takes no account of it.

(2) The provisions of subparagraph (1) 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, 1952, 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 1952 a further distribution of $5,000, being a distribution described in section 113 (b) (1) (D) other than a distribution out of increase of value of property accrued prior to March 1, 1913. 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 1952 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 1953 for $5,000, he realizes in 1953 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.

(c) In the case of property sold on the installment plan, special rules for the taxation of the gain are prescribed in section 44.

§ 39.112 (a) *Statutory provisions; recognition of gain or loss; general rule.*

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.

§ 39.112 (a)-1 *Sales or exchanges.* (a) 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.

(b) Exceptions to the general rule are made by section 112 (b) (1) to (5) inclusive, section 112 (b) (10) and section 112 (l) 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 Internal Revenue Code 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.

(c) The Internal Revenue Code 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))

(d) 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 Internal Revenue Code only if the exchange is one which satisfies both (1) the specific description in the Code 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.

(e) To constitute an exchange within the meaning of section 112 (b) (1) to (5), inclusive, section 112 (b) (10) and section 112 (l) the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

(f) 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. See section 510 of the Merchant Marine Act of 1936, as added by section 7 of the Act of August 4, 1939 (46 U. S. C. 1160 (e)), with respect to nonrecognition of gain in case of the transfer of an obsolete vessel to the Maritime Commission under the provisions of such section. See section 112 (b) (11) with respect to nonrecognition

of gain upon the distribution of stock (other than preferred) in a corporation a party to a reorganization under certain circumstances without the surrender of stock.

§ 39.112 (a)-2 *Use of term "assumption of liabilities."* When used in the regulations prescribed under sections 112 and 113, the terms "assumption of liabilities," "liabilities assumed," or similar expressions include, in addition to cases where personal liabilities of the taxpayer are assumed by another party to the exchange, cases (a) where property of the taxpayer is acquired by another party to the exchange subject to a liability whether or not the taxpayer was himself personally liable, and (b) where, though the property transferred was held by the taxpayer merely subject to a liability, the liability is assumed by another party to the exchange.

§ 39.112 (b) (1) *Statutory provisions; recognition of gain or loss; exchanges solely in kind, property held for productive use or investment.*

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.

§ 39.112 (b) (1)-1 *Property held for productive use in trade or business or for investment.* (a) 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 such section, 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.

(b) 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.

(c) A transfer is not within the provisions of section 112 (b) (1) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer, but such transfer, if otherwise qualified, will be within the provisions of section 112 (c)

(d) Gain or loss is recognized if a taxpayer exchanges (1) Treasury bonds maturing September 15, 1953, for Treasury bonds maturing June 15, 1963, or (2) a real estate mortgage for consolidated farm loan bonds.

§ 39.112 (b) (2) *Statutory provisions; recognition of gain or loss; exchanges solely in kind, stock for stock of same 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.

§ 39.112 (b) (2)-1 *Stock for stock of the same corporation.* (a) 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.

(b) A transfer is not within the provisions of section 112 (b) (2) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer, but such transfer, if otherwise qualified, will be within the provisions of section 112 (c)

§ 39.112 (b) (3)-(5) *Statutory provisions; recognition of gain or loss; exchanges solely in kind, stock for stock on reorganization, gain of corporation; transfer to corporation controlled by transferor*

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. Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered as "other property or money") shall be considered as stock or securities received by such transferor.

[Sec. 112 (b) (5) as amended by sec. 218 (c), Rev. Act 1939]

§ 39.112 (b) (5)-1 *Transfer of property to corporation controlled by transferor* (a) As used in section 112 (b) (5) the phrase "one or more persons" includes individuals, trusts or estates, partnerships, and corporations (see section 3797) 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.

(b) The provisions of section 112 (b) (5) may be illustrated by the following examples:

Example (1). A owns certain real estate which cost him $50,000 in 1930, but which has a fair market value of $150,000 in 1952. 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 1930, but which has a fair market value of $200,000 in 1952. He transfers the property to the N Corporation in 1952 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 1940 to other persons for cash. B realizes a taxable gain of $150,000 on this transaction. (See section 112 (h).)

§ 39.112 (b) (5)-2 *Treatment of assumptions of liabilities*—(a) *Recognition of gain.* For the effect upon the recognition of gain of an assumption of liabilities in a transfer described in section 112 (b) (5), see section 112 (k) and § 39.112 (k)-1.

(b) *Computation of proportionate interests required by section 112 (b) (5)* (1) In any case where an assumption of liabilities is not to be treated as "other property or money" under section 112 (k) the liabilities so assumed are, for the purpose of determining whether the stock or securities received by the trans-

ferors are substantially proportionate to their interests in the property transferred as required by section 112 (b) (5), to be treated as stock or securities received by the transferor whose indebtedness is assumed.

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

Example. A and B are individuals, each of whom owns property with a fair market value of $100,000 on July 1, 1952. There is a purchase money mortgage on A's property of $50,000. On July 1, 1952, A and B organize the X Corporation, to which they transfer the property above described for the entire capital stock of the X Corporation and the assumption by the X Corporation of A's purchase money mortgage. The X Corporation's capital stock is divided as follows: $50,000 to A and $100,000 to B. Nevertheless, for the purposes of determining whether the transferors received stock or securities substantially in proportion to their interests in the properties transferred, as required by section 112 (b) (5), A is deemed to have received stock or securities to the extent of $100,000, since his $50,000 purchase money mortgage, assumed by the X Corporation, is also to be treated as stock or securities received by him. Accordingly, under the facts as stated, the proportions required by section 112 (b) (5) exist.

§ 39.112 (b) (5)-3 *Records to be kept and information to be filed.* (a) 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, including any liabilities of the taxpayer assumed by the controlled corporation. 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.

(b) 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 (including any liabilities assumed by such controlled corporation) 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)

(c) 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.

§ 39.112 (b) (6) *Statutory provisions; recognition of gain or loss; exchanges solely in kind, property received by corporation on complete liquidation of another.*

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 begining 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 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.

§ 39.112 (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 § 39.113 (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 section.

(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 Internal Revenue Code 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 Code 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.

(c) 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.

(d) To constitute a distribution in complete liquidation within the meaning of section 112 (b) (6) the distribution must be (1) made by the liquidating corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation or (2) 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 § 39.22(a)-20.)

(e) If a transaction constitutes a distribution in complete liquidation within the meaning of the Internal Revenue Code 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 Code 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)

(f) The application of these rules may be illustrated by the following example:

Example. On July 1, 1952, 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, 1952, 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, 1952, pursuant to a plan of liquidation adopted on July 1, 1952, 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.

§ 39.112 (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 § 39.112 (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)

§ 39.112 (b) (6)-3 *Liquidations covering more than one taxable year* (a) 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 liquidations shall, in addition to the requirements of § 39.112 (b) (6)-1, be subject to the following requirements:

(1) 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.

(2) 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 district director of internal revenue 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.

(3) 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 6 U. S. C. 15, 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.

(b) Pending the completion of the liquidation, if there is a compliance with subparagraphs (1) (2) and (3) of paragraph (a) and § 39.112 (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 cor-

poration shall be determined in accordance with section 113 (a) (15) (See § 39.113 (a) (15)-1.) However, if the transfer of the property is not completed within the three-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.

§ 39.112 (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 liquidation received by minority shareholders.

§ 39.112 (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 section 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.

§ 39.112 (b) (7) *Statutory provisions; recognition of gain or loss; exchanges solely in kind; election as to recognition of gain in certain corporate liquidations.*

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 December 31, 1950, whether the taxable year of the corporation began on, before, or after January 1, 1951; 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 some one calendar month in 1951 or 1952—

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 subparagraphs (E) and (F).

(B) *Excluded corporation.* The term "excluded corporation" means a corporation which at any time between August 15, 1950, 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 the close of the month in which the transfer in liquidation occurred under subparagraph (A) (ii), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; 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 August 15, 1950, 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 August 15, 1950; 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 the close of the month in which the transfer in liquidation occurred under subparagraph (A) (ii), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed.

[Sec. 112 (b) (7) as added by sec. 120 (a), Rev. Act 1943; amended by sec. 206 (a), Rev. Act 1950; sec. 316 (a), Rev. Act 1951]

§ 39.112 (b) (7)-1 *Corporate liquidation in calendar month in 1952*—(a) *In general.* Section 112 (b) (7) provides a special rule, in the case of certain specifically described complete liquidations of domestic corporations occurring within some one calendar month in 1952, for the treatment of gain on the shares of stock owned by qualified electing shareholders at the time 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 § 39.112 (b) (7)-2. For the basis of property received on such liquidations, see section 113 (a) (18)

(b) *Type of liquidation.* (1) The liquidation must be in pursuance of a plan of liquidation adopted after December 31, 1950, if the liquidation occurs within one calendar month in 1952. The plan may be adopted at any time after December 31, 1950, and before the first distribution under the liquidation occurs. The Code requires that the transfer of all the property, both tangible and intangi-

ble, of the corporation under the liquidation occur entirely within some one calendar month in 1952, but this requirement will be considered to have been complied with if cash is set aside under arrangements for the payment, after the close of such month, of unascertained or contingent liabilities and expenses, and such arrangements are made in good faith and the amount set aside is reasonable. Though it is not necessary that the corporation dissolve in the month 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.

(2) If a transaction constitutes a distribution in complete liquidation within the meaning of the Code and satisfies the requirements of section 112 (b) (7) it is immaterial that it is otherwise described under the local law.

§ 39.112 (b) (7)-2 *Qualified electing shareholder* (a) No corporate shareholder may be a qualified electing shareholder if at any time between August 15, 1950, 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 purpose of determining whether they are qualified electing shareholders: (1) shareholders other than corporations, and (2) corporate shareholders.

(b) 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 § 39.112 (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 at the time 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.

(c) The application of this section may be illustrated by the following example:

Example. The R Corporation has outstanding 20 shares of common stock on July 1, 1952, at the time 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. At that time 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 at such time 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.

(d) 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 stock and not a mere record holder, such as a nominee.

(e) 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.

§ 39.112 (b) (7)-3 *Making and filing of written elections.* An election to be governed by section 112 (b) (7) shall be made on Form 964 (revised) in accordance with the instructions printed thereon and with this section. The original and one copy shall be filed by the shareholder or by the liquidating corporation with the Commissioner of Internal Revenue, Washington 25, D. C., attention of the Audit Service Branch, Audit Division, within 30 days after the adoption of the plan of liquidation. An election shall be considered as timely filed if it is placed in the mail on or before midnight of the 30th day after the adoption of the plan of liquidation, as shown by the postmark on the envelope containing the written election or as shown by other available evidence of the mailing date. Another copy shall 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.

§ 39.112 (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 at the time 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 at the time 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 the last day of the month of liquidation, without diminution by reason of distributions made during such month, and including in such computation all items of income and expense accrued up to the date on which the transfer of all the property under the liquidation is completed; 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 August 15, 1950. The mere replacement after August 15, 1950, of lost or destroyed certificates or instruments acquired on or before August 15, 1950, 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 August 15, 1950." Nor will such an acquisition result from the issuance after August 15, 1950, of certificates of stock in connection with a subscription made and accepted on or before August 15, 1950.

(c) *Treatment of recognized gain.* (1) In the case of a qualified electing shareholder other than a corporation that part of the recognized gain on a share of stock owned at the time of the adoption of the plan of liquidation which is not in excess of his 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 short-term or long-term capital gain, as the case may be.

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

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 block prior to the date of the adoption of a plan of liquidation conform-

ing 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 (computed as provided in section 112 (b) (7)), of $60, its assets consisting of property (other than stock or securities acquired after August 15, 1950, and money) with a fair market value of $240, cash of $75, and stock and securities acquired after August 15, 1950, with a fair market value of $90, all of which assets are distributed in October, 1952, 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 August 15, 1950, 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.

§ 39.112 (b) (7)-5 *Records to be kept and information to be filed with return.* (a) 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 at the time of the adoption of the plan of liquidation, including:

(1) 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;

(2) 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 August 15, 1950;

(3) 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 liquidation; and

(4) A copy of such shareholder's written election to be governed by the provisions of section 112 (b) (7). (See § 39.112 (b) (7)-3.)

(b) For information to be filed by the liquidating corporation, see section 148 (e)

§ 39.112 (b) (8)-(9) *Statutory provisions; recognition of gain or loss; exchanges solely in kind; exchanges and distributions in obedience to orders of Securities and Exchange Commission; property transfers on certain railroad reorganizations.*

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.

(9) *Loss not recognized on certain railroad reorganizations.* No loss shall be recognized if property of a railroad corporation, as defined in section 77m of the National Bankruptcy Act, as amended, is transferred, after December 31, 1938, in pursuance of an order of the court having jurisdiction of such corporation—

(A) In a receivership proceeding, or

(B) In a proceeding under section 77 of the National Bankruptcy Act, as amended,

to a railroad corporation, as defined in section 77m of the National Bankruptcy Act, as amended, organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding. The term "reorganization" as used in this paragraph, shall not be limited by the definition of such term in subsection (g).

[Sec. 112 (b) (9) as added by sec. 142 (a), Rev. Act 1942; amended by sec. 126 (a), Rev. Act 1943]

§ 39.112 (b) (9)-1 *Nonrecognition of loss upon transfer of property of railroad corporation.* (a) For the purpose of section 112 (b) (9) it is unnecessary that the transfer be a direct transfer by the corporation undergoing reorganization or that such reorganization constitute a reorganization within the meaning of section 112 (g) It is sufficient if the transfer is made in pursuance of an order of the court and is an integral step in the consummation of a plan of reorganization approved by the court having jurisdiction of the proceeding. If these conditions are satisfied, no loss is recognized to the transferor upon the ultimate transfer of the property, or to the transferor upon any intermediate transfer.

(b) Section 112 (b) (9) applies only to a transfer resulting in a loss and has no application if the transfer therein described results in a gain.

§ 39.112 (b) (10) *Statutory provisions; recognition of gain or loss; exchanges solely in kind; transfers of property on reorganization of corporations in certain receivership and bankruptcy proceedings.*

SEC. 112. *Recognition of gain or loss.* * * *

(b) *Exchanges solely in kind.* * * *

(10) *Gain or loss not recognized on reorganization of corporations in certain receivership and bankruptcy proceedings.* No gain or loss shall be recognized if property of a corporation (other than a railroad corporation, as defined in section 77m of the National Bankruptcy Act, as amended) is transferred, in a taxable year of such corporation beginning after December 31, 1933, in pursuance of an order of the court having jurisdiction of such corporation—

(A) In a receivership, foreclosure, or similar proceeding, or

(B) In a proceeding under section 77B or Chapter X of the National Bankruptcy Act, as amended,

to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation.

[Sec. 112 (b) (10) as added by sec. 121 (a), Rev. Act 1943]

§ 39.112 (b) (10)-1 *Transfer of property of insolvent corporation in corporate reorganization or receivership proceeding*—(a) *Exchange solely for stock or securities.* (1) Section 112 (b) (10) provides for the nonrecognition of gain or loss upon certain exchanges made in connection with the reorganization of an insolvent corporation, hereinafter referred to in this section and §§ 39.112 (b) (10)-2, 39.112 (c)-1, and 39.112 (g)-1 as a "section 112 (b) (10) reorganization." Section 112 (b) (10) does not apply to a railroad corporation as defined in section 77 (m) of the Bankruptcy Act (11 U. S. C. 205 (m)) In order to qualify as a section 112 (b) (10) reorganization, the transaction must satisfy the express statutory requirements as well as the underlying assumptions and purposes for which the exchange is excepted from the general rule requiring the recognition of gain or loss upon the exchange of property.

(2) Section 112 (b) (10) applies only with respect to a reorganization effected in one of two specified types of court proceedings: (i) Receivership, foreclosure, or similar proceedings, or (ii) corporate reorganization proceedings under section 77B (48 Stat. 912) or Chapter X of the Bankruptcy Act (11 U. S. C. c. 10). The specific statutory requirements are the transfer of property of a corporation, in pursuance of an order of the court having jurisdiction of the corporation in such proceeding, to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation. If the consideration for the transfer consists of other property or money as well as stock and securities, the gain, if any, is recognized in an amount not in excess of such other property and money (see section 112 (d)) but no loss is recognized (see section 112 (e)) As to the assumption of liabilities in an exchange described in section 112 (b) (10) see section 112 (k) and §§ 39.112 (a)-2 and 39.112 (k)-1.

(3) The application of section 112 (b) (10) is to be strictly limited to a transaction of the character set forth in such section. Hence, the section is inapplicable unless there is a bona fide plan of reorganization approved by the court having jurisdiction of the proceeding

and the transfer of the property of the insolvent corporation is made pursuant to such plan. It is unnecessary that the transfer be a direct transfer from the insolvent corporation, it is sufficient if the transfer is an integral step in the consummation of the reoganization plan approved by the court. By its terms, the section has no application to a reorganization consummated by adjustment of the capital or debt structure of the insolvent corporation without the transfer of its assets to another corporation.

(4) As used in section 112 (b) (10) the term "reorganization" is not controlled by the definition of "reorganization" contained in section 112 (g) However, certain basic requirements, implicit in the statute, which are essential to a reorganization under section 112 (g) are likewise essential to qualify a transaction as a reorganization under section 112 (b) (10) Among these requirements 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. Thus, the nonrecognition accorded by section 112 (b) (10) applies only to a genuine reorganization as distinguished from a liquidation and sale of property to either new or old interests supplying new capital and discharging the obligations of the old corporation. For the purpose of determining whether the requisite continuity of interest exists, the interest of creditors who have, by appropriate legal steps, obtained effective command of the property of an insolvent corporation is considered as the equivalent of a proprietary interest But the mere possibility of a proprietary interest is not its equivalent. The determinative and controlling factors are the corporation's insolvency and the effective command by the creditors over its property. The term "insolvent" as used herein refers to insolvency at any time during the course of the proceeding referred to in section 112 (b) (10) either in the sense of excess of liabilities over assets or in the sense of inability to meet obligations as they mature.

(5) A short-term purchase money note is not a security within the meaning of section 112 (b) (10) and the transfer of the properties of the insolvent corporation for cash and deferred payment obligations of the transferee evidenced by short-term notes is a sale and not an exchange.

(b) *Exchange for stock or securities and other property or money.* (1) If an exchange would be within the provisions of section 112 (b) (10) if it were not for the fact that the consideration for the transfer of the property of the insolvent corporation consists not only of stock or securities but also of 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. Property is distributed within the meaning of this section if it is paid over or distributed to shareholders or creditors who have by appropriate legal steps obtained effective command of the property of the corporation. 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))

(2) For the proper treatment of a transaction involving an assumption of liabilities under so much of section 112 (d) or (e) as relates to section 112 (b) (10) see section 112 (k)

§ 39.112 (b) (10)-2 *Records to be kept and information to be filed.* (a) Each corporation a party to a section 112 (b) (10) reorganization shall furnish a complete statement of all facts pertinent to the nonrecognition of gain or loss in connection with the exchange, including:

(1) A certified copy of the plan of reorganization approved by the court in the proceeding, together with a statement showing in full the purposes thereof and in detail all transactions incident, 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 in the exchange, including a statement of all distributions or other disposition made thereof. 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 exchange;

(4) A statement of the amount and nature of any liabilities assumed upon the exchange.

The information required by this section shall be filed as a part of the corporation's return for its taxable year within which the reorganization occurred.

(b) 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 (including any liabilities assumed upon the exchange) 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.

§ 39.112 (b) (11) *Statutory provisions; recognition of gain or loss; exchanges solely in kind, distribution of stock not in liquidation.*

SEC. 112. *Recognition of gain or loss.* * * *

(b) *Exchanges solely in kind.* * * *

(11) *Distribution of stock not in liquidation.* If there is distributed, in pursuance of a plan of reorganization, to a shareholder of a corporation which is a party to the reorganization, stock (other than preferred stock) in another corporation which is a party to the reorganization, without the surrender by such shareholder of stock, no gain to the distributee from the receipt of such stock shall be recognized unless it appears that (A) any corporation which is a party to such reorganization was not intended to continue the active conduct of a trade or business after such reorganization, or (B) the corporation whose stock is distributed was used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization.

[Sec. 112 (b) (11) as added by sec. 317 (a), Rev. Act 1951]

§ 39.112 (b) (11)-1 *Certain distributions of stock on reorganization.* (a) If there is distributed, in pursuance of a plan of reorganization, to a shareholder of a corporation which is a party to the reorganization, stock (other than preferred stock) in another corporation which is a party to the reorganization, without the surrender by such shareholder of stock, no gain to such shareholder from the receipt of such stock shall be recognized, unless it appears that:

(1) Any corporation which is a party to such reorganization was not intended to continue the active conduct of a trade or business after such reorganization, or

(2) The corporation whose stock is distributed was used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization.

(b) For section 112 (b) (11) to be applicable, there must be a reorganization as defined in section 112 (g) (1) and a distribution to shareholders in pursuance of the plan of reorganization. Accordingly, for the purpose of section 112 (b) (11) there must be compliance with the rules prescribed in §§ 39.112 (a)-1, 39.112 (g)-1, and 39.112 (g)-2, relating to reorganizations and to exchanges and distributions. The distributions under section 112 (b) (11) must be of stock in a corporation which is a party to the reorganization, which stock was received in the reorganization.

(c) Section 112 (b) (11) involves cases in which one corporation, in a reorganization as defined in section 112 (g) (1) (D) transfers a part of its assets to another corporation in exchange for stock, and, in pursuance of the plan of reorganization, distributes or causes to be distributed on its behalf to its shareholders, without the surrender by them of stock in the transferor corporation, stock (other than preferred stock) received in the reorganization. For limitations specially applicable under section 112 (b) (11) see § 39.112 (b) (11)-2. The distribution of preferred stock or other property received in the reorganization, or of other property of the transferor corporation, is not within the provisions of section 112 (b) (11)

§ 39.112 (b) (11)-2 *Limitations upon the application of section 112, (b) (11)* (a) The benefits of section 112 (b) (11) are limited to a reorganization in which all of the corporations, parties to the reorganization, are intended to continue the active conduct of a trade or business after the reorganization, and in which

the corporation whose stock is distributed is not used principally as a device for the distribution of earnings and profits to shareholders of any corporation a party to the reorganization. The underlying assumption of section 112 (b) (11) and of the rules applicable to reorganizations is that the reorganization and distribution of stock must result in a continuation of the old business activities and in a continuation of the interests of the shareholders therein.

(b) A corporation shall be considered for the purpose of section 112 (b) (11) to be engaged in the active conduct of a trade or business after the reorganization only if it directly conducts such business or indirectly conducts the business through ownership of stock in another corporation actively conducting the business, which other corporation is a subsidiary (whether or not majority-owned) of the corporation, a party to the reorganization. For the purpose of the preceding sentence, a corporation is considered a subsidiary of another corporation if a majority of its voting stock is owned by the other corporation or if a part of its stock (whether or not a majority of its voting stock) is owned by the other corporation under such circumstances that the policies of the first corporation are directed by the second corporation. The assets, if any, of a corporation used directly in the conduct of a business and stock, if any, held by a corporation in a subsidiary actively conducting a business must constitute a substantial part of all of the assets of the corporation.

(c) Ordinarily, the business reasons (as distinguished from any desire to make a distribution of earnings and profits to the shareholders) which support the reorganization and the distribution of the stock will require the distribution of all of the stock received by the transferor corporation in the reorganization.

(d) The application of this section may be illustrated by the following examples:

Example 1. Corporation A owns and operates several mines and in addition owns 45 percent of the stock of Corporation X, 40 percent of the stock of Corporation Y, and 35 percent of the stock of Corporation Z. Corporation A is the largest single shareholder in each of these corporations, and directs their policies in such manner that these corporations are operated as subsidiaries of Corporation A. Corporations X, Y, and Z are each directly engaged in the active conduct of a trade or business. Corporation A transfers all its stock in Corporations X, Y, and Z to newly organized Corporation B in exchange for all of Corporation B's stock, which stock is distributed pro rata among the shareholders of Corporation A. Corporation B then directs the policies of these corporations in such manner that they are operated as subsidiaries of Corporation B. There are no other relevant facts. The distribution of the stock (other than preferred stock) in Corporation B to the shareholders of Corporation A is within the terms of section 112 (b) (11).

Example 2. Corporation C owns and operates a department store. It decides to provide parking facilities for the customers of the store. In order to provide such facilities, Corporation C enters into a contract to purchase land adjacent to its premises. The purchase price of the land is $100,000 and it is estimated that the cost of developing the parking lot will be $50,000. In order to separate the operations of the parking lot from those of the department store, Corporation C transfers to a newly formed Corporation D $90,000 in cash and $90,000 in bonds, together with the contract for the purchase of the land, in exchange for all the stock of Corporation D, which stock is distributed pro rata among the shareholders of Corporation C. The purchase of the land is completed on the date fixed in the contract, and the parking facilities are developed and operated by Corporation D. There are no other relevant facts. The transfer of the cash, bonds, and contract to Corporation D in exchange for its stock is a reorganization under section 112 (g) (1) and the distribution of stock (other than preferred stock) in Corporation D to the shareholders of Corporation C is within the terms of section 112 (b) (11).

Example 3. Corporation E is engaged in a manufacturing business. The assets of Corporation E include $300,000 in cash and $600,000 in bonds in addition to $450,000 in other assets used in the manufacturing business. Corporation E forms a new corporation, F, to which Corporation E transfers $200,000 in cash and the $600,000 in bonds in exchange for all the stock of Corporation F, which stock is distributed among the shareholders of Corporation E pro rata. At the time of the transaction, there is no clear and definite plan for the acquisition by Corporation F of specific business assets. There are no other relevant facts. The transfer of cash and bonds to Corporation F is not a reorganization under section 112 (g) (1) of the Code; therefore, the distribution of the stock of Corporation F is taxable as a dividend to the extent provided in section 115 (a).

§ 39.112 (c) *Statutory provisions; recognition of gain or loss; gain from exchanges not solely in kind.*

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), or within the provisions of subsection (l), 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 or by subsection (l) 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.

[Sec. 112 (c) as amended by sec. 121 (d) (1), Rev. Act 1943]

§ 31.112 (c)-1 *Receipt of other property or money in tax-free exchange not connected with corporate reorganization.* (a) If in any transaction in which 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 if 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 if 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)).

(b) The application of this section may be illustrated by the following example:

Example. A, who is not a dealer in real estate, in 1952 exchanges real estate, which he purchased (for investment) in 1940 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.

(c) Consideration received in the form of an assumption of liabilities is to be treated as "other property or money" for the purposes of so much of section 112 (c) as relates to section 112 (b) (1) and (2) As to the proper treatment of such consideration for the purposes of so much of section 112 (c) as relates to section 112 (b) (3), see § 39.112 (g)-4, and so much of section 112 (c) as relates to section 112 (b) (5), see section 112 (k).

(d) See section 113 (a) (6) for the basis for determining the gain or loss from the subsequent sale of the property received in exchanges such as described in this section.

(e) As to the receipt of other property or money on an exchange of stock or securities in connection with a section 112 (g) reorganization, see § 39.112 (g)-4; or in connection with a section 112 (b) (10) reorganization, see § 39.112 (l)-1. As to distributions in pursuance of a plan of reorganization which have the effect of a taxable dividend, see § 39.112 (g)-4, in the case of a section 112 (g) reorganization, or § 39.112 (l)-1, in the case of a section 112 (b) (10) reorganization.

§ 39.112 (d)-(e) *Statutory provisions; recognition of gain or loss; gain of corporation from exchanges not solely in kind, loss from exchanges not solely in kind.*

SEC. 112. *Recognition of gain or loss.* * * *

(d) *Same—gain of corporation.* If an exchange would be within the provisions of subsection (b) (4) or (10) 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.

[Sec. 112 (d) as amended by sec. 121 (d) (2), Rev. Act 1943]

(e) *Loss from exchanges not solely in kind.* If an exchange would be within the provisions of subsection (b) (1) to (5), inclusive, or (10), or within the provisions of subsection (l), 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.

[Sec. 112 (e) as amended by sec. 121 (d) (3), Rev. Act 1943]

§ 39.112 (e)-1 *Nonrecognition of loss.* (a) Section 112 (e) 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, or section 112 (b) (10) 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.

(b) As to the nonrecognition of loss upon an exchange described in so much of section 112 (e) as refers to section 112 (l) see § 39.112 (l)-1. As to the basis of the property received in such an exchange for the purpose of determining gain or loss from the subsequent sale thereof, see section 113 (a) (6) 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)

§ 39.112 (f) *Statutory provisions; recognition of gain or loss; involuntary conversion of property.*

SEC. 112. *Recognition of gain or loss.* * * *

(f) *Involuntary conversion.* If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

(1) *Conversion into similar property.* Into property similar or related in service or use to the property so converted, no gain shall be recognized.

(2) *Conversion into money where disposition occurred prior to 1951.* * * * For the purposes of this paragraph and paragraph (3), the term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(3) *Conversion into money where disposition occurred after 1950.* Into money or into property not similar or related in service or use to the converted property, and the disposition of the converted property (as defined in paragraph (2)) occurred after December 31, 1950, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) *Nonrecognition of gain.* If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary may by regulations prescribe. For the purposes of this paragraph—

(i) No property or stock acquired before the disposition of the converted property shall be considered to have been acquired for the purpose of replacing such converted property unless held by the taxpayer on the date of such disposition; and

(ii) The taxpayer shall be considered to have purchased property or stock only if, but for the provisions of section 113 (a) (9), the unadjusted basis of such property or stock would be its cost within the meaning of section 113 (a).

(B) *Period within which property must be replaced.* The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending—

(i) One year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or

(ii) Subject to such terms and conditions as may be specified by the Secretary, at the close of such later date as the Secretary may designate upon application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary may by regulations prescribe.

(C) *Time for assessment of deficiency attributable to gain upon conversion.* If a taxpayer has made the election provided in subparagraph (A), then (i) the statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain upon such conversion is realized, attributable to such gain shall not expire prior to the expiration of three years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe) of the replacement of the converted property or of an intention not to replace, and (ii) such deficiency may be assessed prior to the expiration of such three-year period notwithstanding the provisions of section 272 (f) or the provisions of any other law or rule of law which would otherwise prevent such assessment.

(D) *Time for assessment of other deficiencies attributable to election.* If the election provided in subparagraph (A) is made by the taxpayer and such other property or such stock was purchased prior to the beginning of the last taxable year in which any part of the gain upon such conversion is realized, any deficiency, to the extent resulting from such election, for any taxable year ending before such last taxable year may be assessed (notwithstanding the provisions of section 272 (f) or 275 or the provisions of any other law or rule of law which would otherwise prevent such assessment) at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed.

This subsection shall not apply, in the case of property used by the taxpayer as his principal residence, if the destruction, theft, seizure, requisition, or condemnation of the residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950.

[Sec. 112 (f) as amended by sec. 151 (d), (e), Rev. Act 1942; sec. 318 (b) (1), Rev. Act 1951; sec. 1, Pub. Law 251 (82d Cong.)]

§ 39.112 (f)-1 *Involuntary conversion where disposition of the converted property occurred after December 31, 1950*—(a) *In general.* This section applies only with respect to involuntary conversions where the disposition of the converted property occurred after December 31, 1950. See §§ 29.112 (f)-1 and 29.112 (f)-2 of Regulations 111 (Part 29 of this chapter) for the rules applicable where the disposition of the converted property occurred before January 1, 1951. The term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation. This section applies only with respect to gains; losses from involuntary conversions are recognized or not recognized without regard to this section. This section shall not apply in the case of an involuntary conversion of property used by the taxpayer as his principal residence; see § 39.112 (n)-1. In the case of property used by the taxpayer partially as a principal residence and partially for other purposes, proper allocation shall be made and this section shall apply only with respect to the involuntary conversion of the portion used for such other purposes.

(b) *Conversion into similar property.* If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted only into property similar or related in service or use to the property so converted, no gain shall be recognized. Such nonrecognition of gain is mandatory. If the conversion is, in whole or in part, into money or property not similar or related in service or use to the property so converted, see paragraph (c) of this section.

(c) *Conversion into money or into dissimilar property.* (1) If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted, or the cost of stock of a corporation owning such other property which is purchased by the taxpayer in the acquisition of control of such corporation, if the taxpayer purchased such other property, or such stock, for the purpose of replacing the property so converted and during the period specified in subparagraph (3) of this paragraph.

(2) All of the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized. An election to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph shall be made by including such gain in gross income for such year or years only to such extent. If, at the time of filing such a return, the period within which the converted property must be replaced has expired, or if such an election is not desired, the gain should be included in gross income for such year or years in the regular manner. A failure to so include such gain in gross income in the regular manner shall be deemed to be an election by the taxpayer to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph even though the details in connection with the conversion are not reported in such return. If, after having made an election under section 112 (f) (3) the converted property is not replaced within the required period of time, or replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such recomputation should be in the form of an "amended return" If a decision is made to make an election under section 112 (f) (3) after the filing of the return and the payment of the tax for the year or years in which any of the gain on an involuntary conversion is realized and before the expiration of the period within which the converted property must be replaced, a claim for credit or refund for such year or years should be filed. If the replacement of the converted property occurs in a year or years in which none of the gain on the conversion is realized, all of the details in connection with such replacement shall be reported in the return for such year or years.

(3) The period referred to in subparagraph (1) of this paragraph is the period of time commencing with the date of the disposition of the converted property, or the date of the beginning of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending one year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at the close of such later date as may be designated pursuant to an application of the taxpayer. Such application shall be made prior to the expiration of the one year after the close of the first taxable year in which any part of the gain upon the conversion is realized. Such application shall be made to the Commissioner, or to such person as he may designate, and shall contain all of the details in connection with the involuntary conversion. No extension of time shall be granted pursuant to such an application unless the taxpayer executes a bond, with such surety as the Commissioner may require, in an amount not in excess of twice the estimated additional income taxes (including interest, penalties, and additions to the tax) which would be payable if an election were not made under this section, and conditioned upon the replacement of the converted property within the extended period of time (including any subsequent extensions granted by the Commissioner or such person as he may designate) or the payment of the additional tax attributable to the gain on the conversion (including interest, penalties, and additions to 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. See 6 U. S. C. 15 with respect to the depositing of bonds or notes of the United States in lieu of sureties.

(4) Property or stock purchased before the disposition of the converted property shall be considered to have been purchased for the purpose of replacing the converted property only if such property or stock is held by the taxpayer on the date of the disposition of the converted property. Property or stock shall be considered to have been purchased only if, but for the provisions of section 113 (a) (9) the unadjusted basis of such property or stock would be its cost to the taxpayer within the meaning of section 113 (a) If the taxpayer's unadjusted basis of the replacement property would be determined, in the absence of section 113 (a) (9) under any of the other numbered paragraphs of section 113 (a), the unadjusted basis of the property would not be its cost within the meaning of section 113 (a) For example, if property similar or related in service or use to the converted property is acquired by gift and its basis is determined under section 113 (a) (2), such property will not qualify as a replacement for the converted property.

(5) If a taxpayer makes an election under section 112 (f) (3), any deficiency, for any taxable year in which any part of the gain upon the conversion is realized, which is attributable to such gain may be assessed at any time before the expiration of three years from the date the district director of internal revenue with whom the return for such year has been filed is notified by the taxpayer of the replacement of the converted property or of an intention not to replace, or of a failure to replace, within the required period, notwithstanding the provisions of section 272 (f) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If replacement has been made, such notification shall contain all of the details in connection with such replacement. Such notification should be made in the return for the taxable year or years in which the replacement occurs, or the intention not to replace is formed, or the period for replacement expires, if this return is filed with such district director of internal revenue. If this return is not filed with such district director, then such notification shall be made to such district director at the time of filing this return. If the taxpayer so desires, he may, in either event, also notify such district director before the filing of such return.

(6) If a taxpayer makes an election under section 112 (f) (3) and the replacement property or stock was purchased before the beginning of the last taxable year in which any part of the gain upon the conversion is realized, any deficiency, for any taxable year ending before such last taxable year, which is attributable to such election may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 272 (f) or 275 or the provisions of any law or rule of law which would otherwise prevent such assessment.

(7) If the taxpayer makes an election under section 112 (f) (3) the gain upon the conversion shall be recognized to the extent that the amount realized upon such conversion exceeds the cost of the replacement property or stock regardless of whether such amount is realized in one or more taxable years.

(8) 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.

(9) There is no investment in property similar in character and devoted to a similar use if:

(i) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(ii) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold.

(iii) The owner of a requisitioned tug uses the proceeds to buy barges.

(10) If, in a condemnation proceeding the Government retains out of the award sufficient funds to satisfy special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation, the amount so retained shall be deducted from the gross award in determining the amount of the net award.

§ 39.112 (g) *Statutory provisions; recognition of gain or loss; definition of reorganization.*

SEC. 112. *Recognition of gain or loss.* * * *

(g) *Definition of reorganization.* As used in this section (other than subsection (b) (10) and subsection (l) and in section 113 (other than subsection (a) (22))—

(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 (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another cor-

poration, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) 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 (E) a recapitalization, or (F) 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.

[Sec. 112 (g) as amended by sec. 213 (b), Rev. Act 1939; sec. 121 (d) (4), Rev. Act 1943]

§ 39.112 (g)-1 *Purpose and scope of exception of reorganization exchanges*—(a) *Reorganizations.* As used in the regulations under section 112 (g) the terms "reorganization" and "party to a reorganization" mean only a reorganization or a party to a reorganization as defined in such section. With respect to section 112 (b) (10) reorganizations, see § 39.112 (b) (10)-1.

(b) *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 Internal Revenue Code 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 Code, 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 Code 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 Code 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 Code recognizes as a reorganization the amalgamation (occurring 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 Code, 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.

(c) *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 six 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 sections 112 (c) and 112 (d) 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 Internal Revenue Code referred to in this paragraph 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. The nonrecognition of gain or loss is also prescribed with respect to the distribution in pursuance of a plan of reorganization, to a shareholder of a corporation which is a party to the reorganization, of stock (other than preferred stock) in another corporation which is a party to the reorganization, where such shareholder does not surrender any stock. See section 112 (b) (11) and the regulations thereunder. 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.

§ 39.112 (g)-2 *Definition of terms.* (a) 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.

(b) The words "statutory merger or consolidation" refer to a merger or a consolidation effected in pursuance of the corporation laws of the United States or a State or Territory or the District of Columbia.

(c) 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 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 of Corporation Y, the transaction is not a "reorganization" under section 112 (g) (1) (B)

(d) The same requirements obtain in the case of section 112 (g) (1) (C), relative to the acquisition by one corporation of substantially all the properties of another corporation, except that for the purpose of determining whether the exchange is solely for voting stock of the acquiring corporation any assumption by the acquiring corporation of liabilities of the other shall be disregarded. Though such an assumption does not prevent an exchange from being solely for voting stock for the purposes of the definition of a reorganization contained in section 112 (g) (1) (C), it may in some cases, however, so alter the character of the transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions. Section 112 (g) (1) (C) does not prevent consideration of the effect of an assumption of liabilities on the general character of the transaction but merely provides that the requirement that the exchange be solely for voting stock is satisfied if the only additional consideration is an assumption of liabilities.

(e) 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.

(f) 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 classses of stock of Corporation J, even though such acquisition by Corporation H is from Corporation K.

(g) 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 or distributions as are directly a part of the transaction specifically described as a reorganization in section 112 (g) (1) 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 or distributions 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.

(h) As used in section 112, as well as in other provisions of the Internal Revenue Code, 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.

§ 39.112 (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:

(a) The merger of Corporation A, in accordance with statutory authority, into Corporation B;

(b) The consolidation, pursuant to statutory authority, of Corporations C and D into Corporation E, a new corporation;

(c) 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;

(d) The acquisition by Corporation H, in exchange solely for all or a part of its voting stock (disregarding any assumption of liabilities, as prescribed in § 39.112 (g)–2) of substantially all the properties of Corporation I;

(e) The transfer by Corporation J of all or a part of its assets to Corporation K, if immediately after the transfer Corporation J 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 J 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

(f) The exchange of stock or securities solely for stock or securities of the same corporation in the case of (1) a recapitalization of a corporation, or (2) a mere change in the identity, form, or place of organization of a corporation, however effected.

§ 39.112 (g)–4 *Exchanges in reorganization for stock or securities and other property or money.* (a) 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)).

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. A, in connection with a reorganization, in 1952, exchanges a share of stock in the X Corporation purchased in 1929 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.

(c) 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.

(d) The application of paragraph (c) of this section may be illustrated by the following example:

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 1952 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 1940 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.

(e) 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))

(f) Consideration received in the form of an assumption of liabilities is to be treated as "other property or money" for the purposes of so much of section 112 (c) as relates to section 112 (b) (3) For the proper treatment of an assumption of liabilities under section 112 (d) and so much of section 112 (e) as relates to section 112 (b) (4), see section 112 (k)

§ 39.112 (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 an-

other 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 (a) the earnings or profits of the corporation of the taxable year computed without regard to prior years and (b) 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 § 39.111-1. See § 39.112 (b) (11)-1 with respect to the distribution to a shareholder, in pursuance of a plan of reorganization of stock (other than preferred stock) in another corporation which is a party to the reorganization, without the surrender by such shareholder of stock.

§ 39.112 (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.

(4) A statement of the amount and nature of any liabilities assumed upon 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, including any liabilities assumed upon the exchange. The amount of each kind of stock or securities and other property (other than liabilities assumed upon the exchange) 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 (including any liabilities assumed upon the exchange) 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.

§ 39.112 (h) *Statutory provisions; recognition of gain or loss; definition of control.*

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.

§ 39.112 (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.

§ 39.112 (i) *Statutory provisions; recognition of gain or loss; exchanges involving foreign corporations.*

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.

§ 39.112 (i)-1 *Reorganization with, or transfer of property to or from, a foreign corporation.* (a) A foreign corporation will not be considered a corporation to or from 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 or from 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, including the excess-profits tax imposed by subchapter D of chapter 1 of the Code.

(b) 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 25, 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.

§ 39.112 (j)-(k) *Statutory provisions; recognition of gain or loss; cross reference; assumption of liability.*

SEC. 112. *Recognition of gain or loss.* * * *

(j) *Installment obligations.* For nonrecognition of gain or loss in the case of installment obligations, see section 44 (d).

(k) *Assumption of liability not recognized.* Where upon an exchange the taxpayer receives as part of the consideration property which would be permitted by subsection (b) (4), (5), or (10) of this section to be received without the recognition of gain if it were the sole consideration, and as part of the consideration another party to the exchange assumes a liability of the taxpayer or acquires from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as "other property or money" received by the taxpayer within the meaning of subsection (c), (d), or (e) of this section and shall not prevent the exchange from being within the provisions of subsection (b) (4), (5), or (10); except that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition was a purpose to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose, such assumption or acquisition (in the amount of the liability) shall, for the purposes of this section, be considered as money received by the taxpayer upon the exchange. In any suit or proceeding where the burden is on the taxpayer to prove that such assumption or acquisition is not to be considered as money received by the taxpayer, such bur-

den shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

[Sec. 112 (k) as added by sec. 213 (a), Rev. Act 1939; amended by sec. 121 (d) (5), Rev. Act 1943]

§ 39.112 (k)-1 *Assumption of liabilities not to be taken into account for purpose of recognizing gain or loss*—(a) *General rule.* Section 112 (k) does not affect the rule that liabilities assumed are to be taken into account for the purpose of computing the amount of gain or loss realized under section 111 upon an exchange. Section 112 (k) provides, subject to the exceptions and limitations specified in paragraph (c) of this section, that—

(1) Liabilities assumed are not to be treated as "other property or money" under section 112 (e) or for the purpose of determining the amount of the realized gain which is to be recognized under section 112 (c) or (d), if the transactions would, but for the receipt of "other property or money," have been exchanges of the type described in section 112 (b) (4) (5) or (10); and

(2) If the only type of consideration received by the transferor in addition to that permitted to be received by section 112 (b) (4) (5) or (10) consists of an assumption of liabilities, the transaction, if otherwise qualified, shall be deemed to be within the provisions of section 112 (b) (4) (5) or (10).

(b) *Application of general rule.* The application of paragraph (a) of this section may be illustrated by the following example:

Example. A, an individual, transfers to a controlled corporation property with an adjusted basis of $10,000 in exchange for stock of the corporation with a fair market value of $8,000, cash in the amount of $3,000, and the assumption by the corporation of indebtedness of A amounting to $4,000. A's gain is $5,000, computed as follows:

Stock received	$8,000
Cash received	3,000
Liabilities assumed by transferee	4,000
Total consideration received	15,000
Less: Adjusted basis of property transferred	10,000
Gain realized	5,000

Assuming that the transaction falls within section 112 (c) as a transaction which would have been within section 112 (b) (5) but for the receipt of "other property or money," only so much of such $5,000 gain will be recognized as does not exceed the "other property or money" received. Since section 112 (k) provides that an assumption of liabilities shall not constitute "other property or money" for this purpose, the only "other property or money" received is the $3,000 cash, and the $5,000 realized gain will be recognized only to the extent of $3,000.

(c) *Exceptions and limitations.* The benefits of section 112 (k) do not extend to any exchange involving an assumption of liabilities where it appears that the principal purpose of the taxpayer with respect to such assumption was a purpose to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose. In such cases, the amount of the liabilities assumed shall, for the purpose of determining the amount of gain to be recognized upon the exchange in which the liabilities are assumed, be treated as money received by the taxpayer upon the exchange. In any suit or proceeding where the burden is on the taxpayer to prove that an assumption of liabilities is not to be treated as "other property or money" under section 112 (k) which is the case if the Commissioner determines that the taxpayer's purpose with respect thereto was a purpose to avoid Federal income tax on the exchange or was not a bona fide business purpose and the taxpayer contests such determination by litigation, the taxpayer must sustain such burden by the clear preponderance of the evidence. Thus, the taxpayer must prove his case by such a clear preponderance of all the evidence that the absence of a purpose to avoid Federal income tax on the exchange, or the presence of a bona fide business purpose, is unmistakable.

§ 39.112 (l) *Statutory provisions; recognition of gain or loss; exchanges by security holders in connection with certain corporate reorganizations.*

SEC. 112. *Recognition of gain or loss.* * * * (l) *Exchanges by security holders in connection with certain corporate reorganizations*—(1) *General rule.* No gain or loss shall be recognized upon an exchange consisting of the relinquishment or extinguishment of stock or securities in a corporation the plan of reorganization of which is approved by the court in a proceeding described in subsection (b) (10), in consideration of the acquisition solely of stock or securities in a corporation organized or made use of to effectuate such plan of reorganization.

(2) *Exchange occurring in taxable years beginning prior to January 1, 1943.* * * *

[Sec. 112 (l) as added by sec. 121 (b), Rev. Act 1943]

§ 39.112 (l)-1 *Exchange in connection with reorganization of insolvent corporation*—(a) *In general.* (1) Section 112 (l) and so much of section 112 (c) and (e) as relates to section 112 (l) prescribe the rules relative to the recognition of gain or loss upon certain exchanges made by the holders of stock or securities of an insolvent corporation in connection with a reorganization described in section 112 (b) (10) or so much of section 112 (d) or (e) as relates to section 112 (b) (10). Under section 112 (l) no gain or loss shall be recognized if, pursuant to the plan of reorganization, stock or securities in the insolvent corporation are exchanged solely for stock or securities in the corporation organized or made use of to effectuate such plan. If, in addition to such stock or securities, other property or money is received upon such exchange, gain is recognized to the extent of such other property or money (section 112 (c)), but no loss is recognized (section 112 (e)). As to the basis of the stock or securities or other property acquired upon an exchange under section 112 (l), see section 113 (a) (6)

(2) By thus characterizing as an exchange, and regarding as a single taxable event, the event or series of events resulting in the relinquishment or extinguishment of the stock or securities in the old corporation and the acquisition in consideration thereof, in whole or in part, of stock or securities in the new corporation, the Internal Revenue Code secures uniformity of treatment for the participating security holders, regardless of the particular steps or the procedural devices by which such exchange is effected. Thus, the transaction which qualifies as a reorganization under section 112 (b) (10) may take one of several forms. In a typical creditors' reorganization there may be a transfer of the property of the old corporation to its bondholders, or the bondholders' committee, upon surrender of the bonds, followed by the transfer of such property to the new corporation in consideration of stock in the latter; or there may be a transfer of the bonds to the new corporation in exchange for its stock or securities, followed by the transfer of the property of the old corporation in consideration of the surrender of its bonds. In either event, section 112 (l) treats the result to the participating security holders as an exchange of the securities of the old corporation for securities of the new corporation. In order, however, to qualify as an exchange under section 112 (l) or so much of section 112 (c) or (e) as relates to section 112 (l) the various events resulting in the relinquishment or extinguishment of the old securities and the acquisition of the new securities must be embraced within the plan of reorganization and must be undertaken for reasons germane to the plan. If the event, or series of events, qualifies as an exchange under section 112 (l) or so much of section 112 (c) or (e) as relates to section 112 (l), no antecedent event necessarily a component of the relinquishment or extinguishment of the securities of the old corporation in consideration of the acquisition of the securities of the new corporation shall be considered a transaction or event having consequences for income or excess profits tax purposes.

(b) *Exchange solely for stock or securities.* Section 112 (l) provides that no gain or loss shall be recognized upon an exchange consisting of the relinquishment or extinguishment of stock or securities in an insolvent corporation described in section 112 (b) (10) or so much of section 112 (d) or (e) as relates to section 112 (b) (10) in consideration of the acquisition solely of stock or securities in a corporation organized or made use of to effectuate the plan of reorganization. As used in section 112 (l) and this section the term security does not include a short-term note.

(c) *Exchanges for stock or securities and other property or money.* (1) If an exchange would be within section 112 (l) if it were not for the fact that the property received in the exchange consists not only of stock or securities in the corporation organized or made use of to effectuate the plan of reorganization, but also of other property or money, then

(i) 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

(ii) The loss, if any to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e))

(2) If the distribution of such other property or money by or on behalf of a corporation in the course of a reorganization described in section 112 (b) (10) 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 (i) as a dividend, such 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 (ii) as a gain from the exchange of property the remainder of the gain so recognized.

(3) Consideration received in the form of an assumption of liabilities is to be treated as "other property or money" for the purposes of so much of section 112 (c) as relates to section 112 (l)

§ 39.112 (l)-2 *Records to be kept and information to be filed.* (a) Every taxpayer who receives stock or securities and other property or money upon an exchange described in section 112 (l) or so much of section 112 (c) or (e) as relates thereto, in connection with a corporate reorganization, shall furnish a complete statement of all facts pertinent to the recognition or 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, including any liability assumed upon the exchange. The amount of each kind of stock or securities and other property (other than liabilities assumed upon the exchange) received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

The statement shall be incorporated in the taxpayer's income tax return for the taxable year in which the exchange occurs.

(b) Permanent records in substantial form shall be kept by every taxpayer who participates in an exchange described in section 112 (l) or so much of section 112 (c) or (e) as relates thereto, showing the cost or other basis of the transferred property and the amount of stock or securities and other property or money received (including any liabilities assumed upon the exchange) 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.

§ 39.112 (m) *Statutory provisions; recognition of gain or loss; gain from sale or exchange to effectuate policies of Federal Communications Commission.*

SEC. 112. *Recognition of gain or loss.* * * * (m) *Gain from sale or exchange to effectuate policies of Federal Communications Commission.* If the sale or exchange of property (including stock in a corporation) is certified by the Federal Communications Commission to be necessary or appropriate to effectuate the policies of the Commission with respect to the ownership and control of radio broadcasting stations, such sale or exchange shall, if the taxpayer so elects, be treated as an involuntary conversion of such property within the meaning of subsection (f) of this section. For the purposes of subsection (f) of this section as made applicable by the provisions of this subsection, stock of a corporation operating a radio broadcasting station, whether or not representing control of such corporation, shall be treated as property similar or related in service or use to the property so converted. The part of the gain, if any, upon such sale or exchange to which subsection (f) of this section is not applied shall nevertheless not be recognized, if the taxpayer so elects, to the extent that it is applied to reduce the basis for determining gain or loss upon sale or exchange of property, of a character subject to the allowance for depreciation under section 23 (l), remaining in the hands of the taxpayer immediately after the sale or exchange, or acquired in the same taxable year. The manner and amount of such reduction shall be determined under regulations prescribed by the Commissioner with the approval of the Secretary. Any election made by the taxpayer under this subsection shall be made by a statement to that effect in his return for the taxable year in which the sale or exchange takes place (or, with respect to taxable years beginning before January 1, 1944 * * *) and such election shall be binding for the taxable year and all subsequent taxable years.

[Sec. 112 (m) as added by sec. 123, Rev. Act 1943]

§ 39.112 (m)-1 *Gain from sale or exchange to effectuate policies of Federal Communications Commission.* (a) At the election of the taxpayer, section 112 (m) in effect, postpones the recognition of gain upon the sale or exchange of property, if the Federal Communications Commission certifies such sale or exchange to be necessary or appropriate to effectuate the policies of the Commission with respect to the ownership or control of radio broadcasting stations. Any taxpayer desiring to obtain the benefits of section 112 (m) shall file with the Commissioner of Internal Revenue, or the district director of internal revenue, a certificate from the Federal Communications Commission clearly identifying the property and showing that the sale or exchange of such property is necessary or appropriate to effectuate the policies of the Commission with respect to the ownership and control of radio broadcasting stations. Such certificate shall be accompanied by a detailed statement showing: The kind of property, the date of acquisition, the cost or other basis of the property the date of sale or exchange, the name and address of the transferee, and the amount of money and the fair market value of the property other than money received upon such sale or exchange.

(b) Section 112 (m) applies only in the case of a sale or exchange made necessary by reason of the Federal Communications Commission's policies as to ownership or control of radio facilities. Section 112 (m) does not apply in the case of a sale or exchange made necessary as a result of other matters, such as the operation of a broadcasting station in a manner determined by the Commission to be not in the public interest or in violation of Federal or State law.

(c) An election to have the benefits of section 112 (m) shall be made in the manner prescribed in § 39.112 (m)-4.

§ 39.112 (m)-2 *Nature and effect of election*—(a) *Alternative elections.* (1) A taxpayer entitled to the benefits of section 112 (m) in respect of a sale or exchange of property may elect—

(i) To treat such sale or exchange as an involuntary conversion under the provisions of section 112 (f), or

(ii) To treat such sale or exchange as an involuntary conversion under the provisions of section 112 (f), and in addition elect to reduce the basis of property, in accordance with the regulations prescribed in § 39.112 (m)-3, by all or part of the gain that would otherwise be recognized under section 112 (f), or

(iii) To reduce the basis of property, in accordance with the regulations prescribed in § 39.112 (m)-3, by all or part of the gain realized upon the sale or exchange.

(2) The effect of the provisions of subparagraph (1) of this paragraph is, in general, to grant the taxpayer an election to treat the proceeds of the sale or exchange as the proceeds of an involuntary conversion subject to the provisions of section 112 (f) and a further election to reduce the basis of certain property owned by the taxpayer by the amount of the gain realized upon the sale or exchange to the extent of that portion of the proceeds which is not treated as the proceeds of an involuntary conversion.

(3) An election under section 112 (m) for any taxable year shall be irrevocable and shall be binding for such taxable year and all subsequent taxable years.

(b) *Application of sections 112 (f) and 113 (a) (9)* (1) If the taxpayer elects, either under paragraph (a) (1) (i) or (ii) of this section, to treat the sale or exchange as an involuntary conversion, the provisions of sections 112 (f) and 113 (a) (9) as modified by section 112 (m) together with the regulations prescribed under such sections, shall be applicable to determine the amount of recognized gain and the basis of property acquired as a result of such sale or exchange. For the purposes of section 112 (m) and the regulations thereunder, stock of a corporation operating a radio broadcasting station shall be treated as property similar or related in service or use to the property sold or exchanged. Securities of such a corporation other than stock, or securities of a corporation not operating a radio broadcasting station do not constitute property similar or related in service or use to the property sold or exchanged. If the taxpayer exercises the election referred to in paragraph (a) (1) (i) of this section, the gain realized upon such sale or exchange shall be recognized to the extent of that part of the money received upon the sale or exchange which is not expended in the manner prescribed in section 112 (f) and the regulations thereunder. If, however, the taxpayer exercises the elections referred to in paragraph (a) (1) (ii) of this section, the amount of the gain which would be recognized, determined in the same manner as in the case of an election under paragraph (a) (1)

…) of this section, shall not be recognized but shall be applied to reduce the basis of property, remaining in the hands of the taxpayer after such sale or exchange or acquired by him during the same taxable year, which is of a character subject to the allowance for depreciation under section 23 (l) Such reduction of basis shall be made in accordance with and under the conditions prescribed by § 39.112 (m)-3.

(2) In the application of sections 112 (f) and 113 (a) (9) to determine the recognized gain and the basis of property acquired as a result of a sale or exchange pursuant to an election under paragraph (a) (1) (i) or (ii) of this section, the entire amount of the proceeds of such sale or exchange shall be taken into account.

(c) The application of the provisions of this section may be illustrated by the following example:

Example. A, who makes his return on the calendar year basis, sold in 1952, for $100,000 cash, stock of X Corporation, which operates a radio broadcasting station. The stock had a basis in A's hands of $75,000. Forthwith, A used $50,000 of the proceeds of the sale to purchase stock in Y Corporation, which also operates a radio broadcasting station. The sale was certified by the Federal Communications Commission as provided in section 112 (m) and A elected in his return for the taxable year in which the sale occurred to treat such sale and purchase as an involuntary conversion subject to the provisions of section 112 (f). He also elected at the same time to reduce the basis of depreciable property, in accordance with the provisions of § 39.112 (m)-3, by the amount of gain that would otherwise be recognized under the provisions of section 112 (f), as made applicable by section 112 (m). The determination of the amount to be applied in reduction of basis under § 39.112 (m)-3 and of the basis under section 113 (a) (9) of the stock of Y Corporation purchased by A is as follows:

Application of sections 112 (f) and (m)	
Sale price of X Corporation stock	$100,000
Basis for gain or loss	75,000
Gain realized	25,000
Proceeds of sale	100,000
Amount expended to replace property sold	50,000
Amount not expended in manner prescribed in section 112 (f)	50,000
Realized gain recognized under section 112 (f) (not to exceed unexpended portion of proceeds of sale)	25,000
Amount applied in reduction of basis	25,000
Gain recognized for tax purposes	None
Application of section 113 (a) (9)	
Basis of property sold (converted)	75,000
Decreased in amount of proceeds not expended under section 112 (f)	50,000
Balance	25,000
Increased in amount of gain recognized under section 112 (f)	25,000
Basis of Y Corporation stock in A's hands	50,000

§ 39.112 (m)-3 *Reduction of basis of property pursuant to election under section 112 (m)*—(a) *General rule.* (1) In addition to the adjustments provided in section 113 (b) and the sections of the regulations relating thereto, which are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in the amount of the unrecognized gain under section 112 (m) if the taxpayer so elects. Such further adjustment shall be made only with respect to the cost or other basis of property which is of a character subject to the allowance for depreciation under section 23 (l) and which remains in the hands of the taxpayer immediately after the sale or exchange in respect of which the election is made, or which is acquired by the taxpayer in the same taxable year in which such sale or exchange occurs. If the property is in the hands of the taxpayer immediately after the sale or exchange, the time of reduction of the basis is the date of the sale or exchange; in all other cases the time of reduction of the basis is the date of acquisition.

(2) The reduction of basis under section 112 (m) in the amount of the unrecognized gain shall be made in respect of the cost or other basis, as of the time prescribed, of all units of property of the specified character. The cost or other basis of each unit shall be decreased in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) of such unit bears to the aggregate of such adjusted bases of all units of such property, but the amount of the decrease shall not be more than the amount of such adjusted basis. If in the application of such rule the adjusted basis of any unit is reduced to zero, the process shall be repeated to reduce the adjusted basis of the remaining units of property by the portion of the unrecognized gain which is not absorbed in the first application of the rule. For such purpose the "adjusted basis" of the remaining units shall be the adjusted basis for determining gain reduced by the amount of the adjustment previously made under this section. The process shall be repeated until the entire amount of the unrecognized gain has been absorbed.

(b) *Special cases.* With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property of the class specified in section 112 (m) and this section adjusted in a manner different from the general rule set forth in paragraph (a) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of such property. The request for variations from such general rule should be filed by the taxpayer with his return for the taxable year in which he elects to have the basis of property reduced under section 112 (m) Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 3760.

§ 39.112 (m)-4 *Manner of election.* (a) An election under the provisions of section 112 (m) shall be in the form of a written statement and shall be executed and filed in duplicate. Such statement shall be signed by the taxpayer or his authorized representative. In the case of a corporation the statement shall be signed with the corporate name, followed by the signature and title of at least two officers of the corporation empowered to sign for the corporation, and the corporate seal must be affixed. An election under section 112 (m) to reduce the basis of property and an election under such section to treat the sale or exchange as an involuntary conversion under section 112 (f) may be exercised independently of each other. An election under section 112 (m) must be filed with the return for the taxable year in which the sale or exchange occurs. Where practicable, the certificate of the Federal Communications Commission required by § 39.112 (m)-1 should be filed with the election.

(b) If, in pursuance of an election to have the basis of its property adjusted under section 112 (m) the taxpayer desires to have such basis adjusted in any manner different from the general rule set forth in § 39.112 (m)-3 (a) the precise method (including allocation of amounts) should be set forth in detail on separate sheets accompanying the election. Consent by the Commissioner to any departure from such general rule shall be effected only by a closing agreement entered into under the provisions of section 3760.

§ 39.112 (n) *Statutory provisions; recognition of gain or loss; gain from sale or exchange of residence.*

SEC. 112. *Recognition of gain or loss.* * * *

(n) *Gain from sale or exchange of residence*—(1) *Nonrecognition of gain.* If property (hereinafter in this subsection called "old residence") used by the taxpayer as his principal residence is sold by him and, within a period beginning one year prior to the date of such sale and ending one year after such date, property (hereinafter in this subsection called "new residence") is purchased and used by the taxpayer as his principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's selling price of the old residence exceeds the taxpayer's cost of purchasing the new residence.

(2) *Rules for application of subsection.* For the purposes of this subsection:

(A) An exchange by the taxpayer of his residence for other property shall be considered as a sale of such residence, and the acquisition of a residence upon the exchange of property shall be considered as a purchase of such residence.

(B) If the taxpayer's residence (as a result of its destruction in whole or in part, theft, or seizure) is compulsorily or involuntarily converted into property or into money, such destruction, theft, or seizure shall be considered as a sale of the residence; and if the residence is so converted into property which is used by the taxpayer as his residence, such conversion shall be considered as a purchase of such property by the taxpayer.

(C) In the case of an exchange or conversion described in subparagraph (A) or (B), in determining the extent to which the

selling price of the old residence exceeds the taxpayer's cost of purchasing the new residence, the amount realized by the taxpayer upon such exchange or conversion shall be considered the selling price of the old residence.

(D) A residence any part of which was constructed or reconstructed by the taxpayer shall be considered as purchased by the taxpayer. In determining the taxpayer's cost of purchasing a residence, there shall be included only so much of his cost as is attributable to the acquisition, construction, reconstruction, and improvements made which are properly chargeable to capital account, during the period specified in paragraph (1).

(E) If a residence is purchased by the taxpayer prior to the date of his sale of the old residence, the purchased residence shall not be treated as his new residence if sold or otherwise disposed of by him prior to the date of the sale of the old residence.

(F) If the taxpayer, during the period described in paragraph (1), purchases more than one residence which is used by him as his principal residence at some time within one year after the date of the sale of the old residence, only the last of such residences so used by him after the date of such sale shall constitute the new residence. If within the one year referred to in the preceding sentence property used by the taxpayer as his principal residence is destroyed, stolen, seized, requisitioned, or condemned, or is sold or exchanged under threat or imminence thereof, then for the purposes of the preceding sentence such one year shall be considered as ending with the date of such destruction, theft, seizure, requisition, condemnation, sale, or exchange.

(G) In the case of a new residence the construction of which was commenced by the taxpayer prior to the expiration of one year after the date of the sale of the old residence, the period specified in paragraph (1), and the one year referred to in subparagraph (F) of this paragraph, shall be considered as including a period of 18 months beginning with the date of the sale of the old residence.

(3) *Limitation.* The provisions of paragraph (1) shall not be applicable with respect to the sale of the taxpayer's residence if within one year prior to the date of such sale the taxpayer sold at a gain other property used by him as his principal residence, and any part of such gain was not recognized by reason of the provisions of paragraph (1). For the purposes of this paragraph, the destruction, theft, seizure, requisition, or condemnation of property or the sale or exchange of property under threat or imminence thereof, shall not be considered as a sale of such property.

(4) *Basis of new residence.* Where the purchase of a new residence results, under paragraph (1), in the nonrecognition of gain upon the sale of an old residence, in determining the adjusted basis of the new residence as of any time following the sale of the old residence, the adjustments to basis shall include a reduction by an amount equal to the amount of the gain not so recognized upon the sale of the old residence. For this purpose, the amount of the gain not so recognized upon the sale of the old residence includes only so much of such gain as is not recognized by reason of the cost, up to such time, of purchasing the new residence.

(5) *Tenant-stockholder in a cooperative apartment corporation.* For the purposes of this subsection, section 113 (b) (1) (K), and section 117 (h) (7), references to property used by the taxpayer as his principal residence, and references to the residence of a taxpayer, shall include stock held by a tenant-stockholder (as defined in section 23 (z) (2)) in a cooperative apartment (as defined in such section) if—

(A) In the case of stock sold, the apartment which the taxpayer was entitled to occupy as such stockholder was used by him as his principal residence, and

(B) In the case of stock purchased, the taxpayer used as his principal residence the apartment which he was entitled to occupy as such stockholder.

(6) *Husband and wife.* If the taxpayer and his spouse, in accordance with regulations which shall be prescribed by the Secretary pursuant to this paragraph, consent to the application of subparagraph (B) of this paragraph, then—

(A) For the purposes of this subsection, the words "taxpayer's selling price of the old residence" shall mean the selling price (of the taxpayer, or of the taxpayer and his spouse) of the old residence, and the words "taxpayer's cost of purchasing the new residence" shall mean the cost (to the taxpayer, his spouse, or both) of purchasing the new residence (whether held by the taxpayer, his spouse, or the taxpayer and his spouse); and

(B) So much of the gain upon the sale of the old residence as is not recognized solely by reason of this paragraph, and so much of the adjustment under paragraph (4) to the basis of the new residence as results solely from this paragraph, shall be allocated between the taxpayer and his spouse as provided in such regulations.

This paragraph shall apply only if the old residence and the new residence are each used by the taxpayer and his spouse as their principal residence. In case the taxpayer and his spouse do not consent to the application of subparagraph (B) of this paragraph, then the recognition of gain upon the sale of the old residence shall be determined under this subsection without regard to the rules provided in this paragraph.

(7) *Statute of limitations.* If the taxpayer during a taxable year sells at a gain property used by him as his principal residence, then—

(A) The statutory period for the assessment of any deficiency attributable to any part of such gain shall not expire prior to the expiration of three years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe) of—

(i) The taxpayer's cost of purchasing the new residence which the taxpayer claims results in nonrecognition of any part of such gain,

(ii) The taxpayer's intention not to purchase a new residence within the period specified in paragraph (1), or

(iii) A failure to make such purchase within such period; and

(B) Such deficiency may be assessed prior to the expiration of such three-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

(8) *Members of Armed Forces.* The running of any period of time specified in paragraph (1) or (2) (other than the one year referred to in paragraph (2) (F)) of this subsection shall be suspended during any time that the taxpayer (or his spouse if the old residence and the new residence are each used by the taxpayer and his spouse as their principal residence) serves on extended active duty with the Armed Forces of the United States after the date of the sale of the old residence and before January 1, 1954, except that any such period as so suspended shall not extend beyond the date four years after the date of the sale of the old residence. For the purpose of this paragraph, the term "extended active duty" means any period of active duty pursuant to a call or order to such duty for a period in excess of ninety days or for an indefinite period.

[Sec. 112 (n) as added by sec. 318 (a), Rev. Act 1951; amended by sec. 1 Pub. Law 507 (82d Cong.)]

§ 39.112 (n)-1 *Gain from sale or exchange of residence*—(a) *In general.* Gain from a sale of property used by the taxpayer as his principal residence (referred to in this section as the "old residence") will not be recognized if the taxpayer within a period beginning one year before the date of such sale and ending one year after such date purchases property and uses it as his principal residence (referred to in this section as the "new residence") except to the extent that the taxpayer's selling price of the old residence exceeds the taxpayer's cost of purchasing the new residence. In the case of a new residence the construction of which was commenced by the taxpayer at any time before the expiration of one year after the date of the sale of the old residence, the one year after the sale of the old residence referred to in the preceding sentence shall be considered as including a period of 18 months beginning with the date of the sale of the old residence. Such nonrecognition of gain is mandatory. This section applies only with respect to gains; losses from sales of property used by the taxpayer as his principal residence are recognized or not recognized without regard to this section.

(b) *Rules for application of section*—(1) *Property used by the taxpayer as his principal residence.* (i) Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence) depends upon all of the facts and circumstances in each individual case, including the bona fides of the taxpayer. The mere fact that property is, or has been, rented is not determinative that such property is not used by the taxpayer as his principal residence. For example, if the taxpayer purchases his new residence before he sells his old residence, the fact that he temporarily rents out the new residence during the period before he vacates the old residence may not, in the light of all the facts and circumstances in the case, prevent the new residence from being considered as property used by the taxpayer as his principal residence. Property used by the taxpayer as his principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative apartment corporation (as those terms are defined in section 23 (z) (2)), if the apartment which the taxpayer is entitled to occupy as such stockholder is used by him as his principal residence. Property used by the taxpayer as his principal residence does not include personal property such as a piece of furniture, a radio, etc., which, in accordance with the applicable local law is not a fixture.

(ii) Where part of a property is used by the taxpayer as his principal residence and part is used for other purposes, an allocation must be made to determine the application of this sec-

tion. If the old residence is used only partially for residential purposes, only that part of the gain allocable to the residential portion may be not recognized under this section and only an amount allocable to the selling price of such portion need be reinvested in the new residence in order to have the gain allocable to such portion not recognized under this section. If the new residence is used only partially for residential purposes, only so much of its cost as is allocable to the residential portion may be counted as the cost of purchasing the new residence.

(2) *Sale of residence.* For the purpose of this section, an exchange by the taxpayer of his residence for other property shall be considered as a sale of such residence. Also, if the taxpayer's residence (as a result of its destruction in whole or in part, theft, seizure, requisition or condemnation) is compulsorily or involuntarily converted into money or property, the destruction, theft, seizure, requisition or condemnation shall be considered as a sale of such residence.

(3) *Purchase of residence.* For the purpose of this section, the acquisition of a residence upon the exchange of property shall be considered as a purchase of such residence. Also, the acquisition of a residence upon the compulsory or involuntary conversion of the taxpayer's residence as the result of its destruction in whole or in part, theft, seizure, requisition or condemnation shall be considered to be a purchase of the residence. A residence any part of which was constructed or reconstructed by the taxpayer shall be considered as purchased by the taxpayer, but the mere improvement of a residence, not amounting to reconstruction, does not constitute a purchase of a residence.

(4) *Selling price of old residence.* The taxpayer's selling price of the old residence includes the amount of any mortgage, trust deed, or other indebtedness to which such property is subject in the hands of the purchaser whether or not the purchaser assumed such indebtedness. Such selling price also includes the face amount of any liabilities of the purchaser which are part of the consideration for the sale. Commissions and other selling expenses paid or incurred by the taxpayer on the sale of the old residence are not to be deducted or taken into account in determining such selling price. In the case of an exchange or conversion which is considered as a sale under this section, the amount realized by the taxpayer upon such exchange or conversion shall be considered to be the taxpayer's selling price of the old residence. As to what constitutes the amount realized, see § 39.111-1.

(5) *Cost of purchasing new residence.* The taxpayer's cost of purchasing the new residence also includes such indebtedness to which the property purchased is subject at the time of purchase whether or not assumed by the taxpayer (including purchase-money mortgages, etc.) and the face amount of any liabilities of the taxpayer which are part of the consideration for the purchase. Commissions and other purchasing expenses paid or incurred by the taxpayer on the purchase of the new residence are to be included in determining such cost. In the case of an acquisition of a residence upon an exchange or conversion which is considered as a purchase under this section, the fair market value of the new residence shall be considered as the taxpayer's cost of purchasing the new residence. The taxpayer's cost of purchasing the new residence includes only so much of such cost as is attributable to acquisition, construction, reconstruction, or improvements made within the two-year or 30 months period of time, as the case may be, in which the purchase and use of the new residence must be made in order to have gain on the sale of the old residence not recognized under this section. Such cost also includes only such amounts as are properly chargeable to capital account rather than to current expense. As to what constitutes capital expenditures, see § 39.24 (a)-2. Where any part of the new residence is acquired by the taxpayer other than by purchase, the value of such part is not to be included in determining the taxpayer's cost of the new residence. For example, if the taxpayer acquires a residence by gift or inheritance, and spends $20,000 in reconstructing such residence, only such $20,000 may be treated as his cost of purchasing the new residence.

(6) *Selling price and cost of residence in the case of husband and wife.* (i) If the taxpayer and his spouse file the consent referred to in this subdivision, then the "taxpayer's selling price of the old residence" shall mean the taxpayer's or the taxpayer and his spouse's selling price of the old residence, and the "taxpayer's cost of purchasing the new residence" shall mean the cost to the taxpayer, or to his spouse, or to both of them, of purchasing the new residence, whether such new residence is held by the taxpayer, or his spouse, or both. Such consent may be filed only if the old residence and the new residence are each used by the taxpayer and his same spouse as their principal residence. If the taxpayer and his spouse do not file such a consent, the recognition of gain upon sale of the old residence shall be determined under this section without regard to the foregoing.

(ii) The consent referred to in subdivision (i) of this subparagraph is a consent by the taxpayer and his spouse to have the basis of the interest of either of them in the new residence reduced from what it would have been but for the filing of such consent by an amount by which the gain of either of them on the sale of his interest in the old residence is not recognized solely by reason of the filing of such consent. Such reduction in basis is applicable to the basis of the new residence, whether such basis is that of the husband, of the wife, or divided between them. If the basis is divided between the husband and wife, the reduction in basis shall be divided between them in the same proportion as the basis (determined without regard to such reduction) is divided between them. Such consent shall be filed with the district director of internal revenue with whom the return for the taxable year or years in which the gain from the sale of the old residence is realized has been filed.

(iii) The following examples will illustrate the application of this rule:

Example (1). A taxpayer, in 1952, sells for $10,000 the principal residence of himself and his wife, which he owns individually and which has an adjusted basis to him of $5,000. Within a year after such sale he and his wife contribute $5,000 each from their separate funds for the purchase of their new principal residence which they hold as tenants in common, each owning an undivided one-half interest therein. If the taxpayer and his wife file the required consent, the gain of $5,000 upon the sale of the old residence will not be recognized to the taxpayer, and the adjusted basis of the taxpayer's interest in the new residence will be $2,500 and the adjusted basis of his wife's interest in such property will be $2,500.

Example (2). A taxpayer and his wife, in 1952, sell for $10,000 their principal residence, which they own as joint tenants and which has an adjusted basis of $2,500 to each of them ($5,000 together). Within a year after such sale, the wife spends $10,000 of her own funds in the purchase of a principal residence for herself and the taxpayer and takes title in her name only. If the taxpayer and his wife file the required consent, the adjusted basis to the wife of the new residence shall be $5,000, and the gain of the taxpayer of $2,500 upon the sale of the old residence will not be recognized. The wife, as a taxpayer herself, will have her gain of $2,500 on the sale of the old residence not recognized under the general rule.

(c) *Basis of new residence.* (1) Where the purchase of a new residence results, under this section, in the nonrecognition of any part of the gain realized upon the sale of an old residence, then, in determining the adjusted basis of the new residence as of any time following the sale of the old residence, the adjustments to basis shall include a reduction by an amount equal to the amount of the gain which was not recognized upon the sale of the old residence. Such a reduction is not to be made for the purpose of determining the adjusted basis of the new residence as of any time preceding the sale of the old residence. For the purpose of this determination, the amount of the gain not recognized under this section upon the sale of the old residence includes only so much of the gain as is not recognized because of the taxpayer's cost, up to the date of the determination of the adjusted basis, of purchasing the new residence.

(2) The following example will illustrate the rule of subparagraph (1)

Example. On January 1, 1952, the taxpayer buys a new residence for $10,000. On March 1, 1952, he sells for $15,000 his old residence which has an adjusted basis to him of $5,000. During April a wing is constructed on the new house at a cost of $5,000 and in May he builds a garage at a cost of $2,000. The adjusted basis of the new residence is $10,000 during January and February, $5,000 during March and April, and $7,000 following the completion of the construction in May.

(d) *Limitations on application of section.* (1) If a residence is purchased by the taxpayer prior to the date of the sale

of the old residence, the purchased residence shall, in no event, be treated as a new residence if such purchased residence is sold or otherwise disposed of by him prior to the date of the sale of the old residence. And, if the taxpayer, during the period within which the purchase and use of the new residence must be made in order to have any gain on the sale of the old residence not recognized under this section, purchases more than one property which is used by him as his principal residence during the one year (or 18 months in the case of the construction of the new residence) succeeding the date of the sale of the old residence, only the last of such properties shall be considered a new residence. However, if the taxpayer's new residence is destroyed, stolen, seized, requisitioned, condemned, or sold or exchanged under the threat or imminence of requisition or condemnation within such year (or 18 months) succeeding the sale of the old residence, then, for the purpose of the preceding sentence, such year (or 18 months) is deemed to end on the date of the destruction, theft, seizure, requisition, condemnation, sale, or exchange. If within one year before the date of the sale of the old residence, the taxpayer sold other property used by him as his principal residence at a gain, and any part of such gain was not recognized under this section, this section shall not apply with respect to the sale of the old residence. For the purpose of the preceding sentence, however, the destruction, theft, seizure, requisition, condemnation, or sale or exchange under threat or imminence of requisition or condemnation shall not be considered as a sale.

(2) The following example will illustrate the rules of subparagraph (1)

Example. A taxpayer sells his old residence on January 15, 1952, and purchases a new residence on February 15, 1952. On March 15, 1952, he sells the new residence and purchases a second new residence on April 15, 1952. The gain on the sale of the old residence on January 15, 1952, will not be recognized except to the extent to which the taxpayer's selling price of the old residence exceeds the cost of purchasing the second new residence purchased on April 15, 1952. Gain on the sale of the first new residence on March 15, 1952, will be recognized. If, instead of selling the first new residence on March 15, 1952, such residence had been destroyed by fire on that date and insurance proceeds in cash had been received as a result thereof, the gain on the sale of the old residence on January 15, 1952, will not be recognized except to the extent to which the taxpayer's selling price of the old residence exceeds his cost of purchasing the new residence purchased on February 15, 1952. And, the gain on the involuntary conversion by fire of the first new residence on March 15, 1952, will not be recognized except to the extent to which the amount realized from such conversion exceeds the taxpayer's cost of purchasing the second new residence purchased on April 15, 1952.

(e) *Statute of limitations.* (1) Whenever a taxpayer sells property used as his principal residence at a gain, the statutory period prescribed in section 275 for the assessment of any deficiency attributable to any part of such gain will not expire prior to the expiration of three years from the date the district director of internal revenue, with whom the return for the taxable year or years in which the gain from the sale of the old residence is realized has been filed, is notified by the taxpayer (i) of the cost of purchasing the new residence which the taxpayer claims results in the nonrecognition of any part of such gain, or (ii) of the taxpayer's intention not to, or failure to, purchase a new residence within the period when such a purchase will result in the nonrecognition of any part of such gain. Such a deficiency may be assessed before the expiration of such three-year period notwithstanding the provisions of any other law or rule of law which might otherwise bar such assessment.

(2) If the return for the taxable year or years in which the purchase of the new residence occurs, or the intention not to make such a purchase is formed, or the period for the replacement expires, is filed with the district director of internal revenue with whom the taxpayer filed his return for the taxable year or years in which the gain from the sale of the old residence was realized, the taxpayer shall give to such district director the notification described in subparagraph (1) of this paragraph in his return for the taxable year or years in which such purchase occurs, or such intention is formed, or such period expires. However, if the return for the taxable year or years in which such purchase occurs, or such intention is formed, or such period expires, is filed with a different district director of internal revenue, the taxpayer, at the time of filing such return, shall give such notification to the district director of internal revenue with whom the taxpayer filed his return for the taxable year or years in which the gain from the sale of the old residence was realized. In addition to giving such notification at the time he files his return for the taxable year or years in which such purchase occurs, or such intention is formed, or such period expires, the taxpayer may, if he so desires, in either event, also notify such district director before the filing of such return. Such notification shall contain all of the details in connection with the sale of the residence and, if applicable, the purchase of the new residence. If an intention not to replace is formed, or if the period for replacement expires, or if the cost of purchasing the new residence is less than the selling price of the old residence, the recognizable gain shall be included in the gross income for the taxable year or years in which such gain was realized; a recomputation in the form of an "amended return" should be made for this purpose if necessary.

(f) *Members of Armed Forces.* (1) The running of the one-year (or 18 months in the case of the construction of the new residence) period, specified in paragraph (a) of this section, after the sale of the old residence within which the purchase and use of a new residence may result in the nonrecognition of gain on such sale shall be suspended during any time that the taxpayer serves on extended active duty in the Armed Forces of the United States after the date of the sale of the old residence and before January 1, 1954. Any such period as so suspended, however, shall not extend beyond the date four years after the date of the sale of the old residence. For example, if the taxpayer is on extended active duty with the army from January 1, 1951, to December 31, 1953, and if he sold his old residence on January 1, 1951, the latest date on which the taxpayer may use a new residence constructed by him and have any part of the gain on the sale of the old residence not recognized under this section is January 1, 1955, the date four years after the date of sale of the old residence.

(2) This suspension covers not only the Armed Forces service of the taxpayer but if the taxpayer and his same spouse used both the old and the new residences as their principal residence, then the extension applies in like manner to the time the taxpayer's spouse is on extended active duty with the Armed Forces of the United States.

(3) The time during which the running of the period is suspended is part of such period. Thus, construction costs during such time are includible in the cost of purchasing the new residence under paragraph (b) (5) of this section.

(4) The running of the one-year (or 18 month) periods referred to in paragraph (d) of this section is not suspended, nor is the running of the one-year period prior to the date of the sale of the old residence within which the new residence may be purchased in order to have gain on the sale of the old residence not recognized under this section.

(5) The term "extended active duty" means any period of active duty which is served pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. If the call or order is for a period of more than 90 days, it is immaterial that the time served pursuant to such call or order is less than 90 days, if the reason for such shorter period of service occurs after the beginning of such duty. As to what constitutes active service as a member of the Armed Forces of the United States, see § 39.22 (b) (13)-1. As to who are members of the Armed Forces of the United States, see § 39.3797-11.

§ 39.113 (a) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; general rule.*

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—* * *

§ 39.113 (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 section and §§ 39.113 (a)-2 to 39.113 (a) (22)-1, inclusive, has reference to the unadjusted basis. For special rules for determining the basis for gain or loss

in the case of vessels acquired through the Maritime Commission (or its successor) see sections 510 and 511 of the Merchant Marine Act of 1936 (46 U. S. C. 1160, 1161) For special rules for determining the unadjusted basis of property recovered in respect of war losses, see section 127 (d) For special rules for determining the basis for gain or loss in the case of the disposition of a share of stock acquired pursuant to the timely exercise of a restricted stock option where the option price was between 85 percent and 95 percent of the fair market value of the stock at the time the option was granted, see section 130A (b). For special rules for determining the basis, both unadjusted and adjusted, of property acquired or improved with the proceeds of a grant or loan made to a taxpayer by the United States for the encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, see section 22 (b) (15)

§ 39.113 (a)-2 *General rule.* In general, the basis of property is the cost thereof. This rule is subject, however, to the exceptions stated in sections 113 (a) (1) to 113 (a) (23) inclusive.

§ 39.113 (a) (1) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; inventory items.*

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.

§ 39.113 (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 §§ 39.22 (c)-1 to 39.22 (d)-7, inclusive.

§ 39.113 (a) (2) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; gifts after December 31, 1920.*

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 if such basis (adjusted for the period prior to the date of the gift as provided in subsection (b)) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value. 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.

[Sec. 113 (a) (2) as amended by sec. 143 (a), Rev. Act 1942]

§ 39.113 (a) (2)-1 *Property transmitted by gift after December 31, 1920*—(a) *Property included.* (1) Section 113 (a) (2) applies to all property acquired after December 31, 1920, by gift. It does not apply

(i) To property acquired by devise or bequest (see section 113 (a) (5)), or

(ii) To property acquired by an instrument which, under section 113 (a) (5) is to be treated as though it were a will.

(2) Section 113 (a) (2) applies to all gifts of whatever description, 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; or whether made by means of the exercise (other than by will) of a power of appointment or revocation, or any other power. Section 113 (a) (2) applies whether the gift was made by a transfer in trust or otherwise.

(b) *Basis.* (1) 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, except that in any case in which such basis, adjusted for the period prior to the date of the gift as provided in section 113 (b) is greater than the fair market value of the property at the time of the gift, the basis is such fair market value.

(2) 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 receives the property immediately upon the transfer by the donor, or as remainderman under the instrument of gift, or whether such person is any other person to whom such uniform basis is applicable. Such uniform basis applies to the property in the hands of the trustee or the beneficiary under a gift instrument, both during the term of the trust and after the 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 § 39.113 (a) (5)-1.

(3) 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 section, 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 terms of the gift (as, for example, in the case of a sale by the fiduciary of property transferred under the terms of the 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) of this section.

(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.

§ 39.113 (a) (3) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; transfers in trust after December 31, 1920.*

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 gift, 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.

[Sec. 113 (a) (3) as amended by sec. 143 (b), Rev. Act 1942]

§ 39.113 (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 by bequest or devise, by an instrument which, under section 113 (a) (5) is to be treated as though it were a will, or to property acquired as a gift by transfer in trust made at any time after December 31, 1920. 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 property was acquired as a gift by transfer in trust, 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) of this section.

§ 39.113 (a) (4) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; gifts or transfers in trust before January 1, 1921.*

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.

§ 39.113 (a) (4)-1 *Gift or transfer in trust before 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 § 39.113 (a) (2)-1, or by equivalent methods.

§ 39.113 (a) (5) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property transmitted at death.*

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. In the case of an election made by the executor under section 811 (j), the time of acquisition of the property shall, for the purpose of this paragraph, be the applicable valuation date of the property prescribed by such section in determining the value of the gross estate. For the purposes of this paragraph the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, Territory or possession of the United States or any foreign country shall be considered to be property "acquired by bequest, devise, or inheritance" from the decedent, if the death of the decedent was after December 31, 1947, and if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under section 811. In the case of property held by a decedent and his surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, if the value of any part of the surviving spouse's one-half share of such property was included in determining the value of the gross estate of the decedent and a tax under chapter 3 was payable upon the transfer of the net estate of the decedent, then for the purposes of this paragraph such part of such one-half share of the surviving spouse shall be considered to be property "acquired by bequest, devise, or inheritance" from the decedent, if the death of the decedent was after the date of the enactment of the Revenue Act of 1942 and on or before December 31, 1947; but nothing in this sentence shall reduce basis below that which would exist if the Revenue Act of 1948 had not been enacted. For the purposes of this paragraph, the survivor's interest in a joint and survivor's annuity shall be considered to be property "acquired by bequest, devise, or inheritance" from the decedent if the death of the decedent was after December 31, 1950, and if the value of any part of such interest was required to be included in determining the value of the decedent's gross estate under section 811.

[Sec. 113 (a) (5) as amended by sec. 144 (a), Rev. Act 1942; sec. 366, Rev. Act 1948; sec. 303 (b), Rev. Act 1951]

§ 39.113 (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;

(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) and

(3) To (i) the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property law of any State, Territory, or possession of the United States or any foreign country, if the death of the decedent is after December 31, 1947, and if at least one-half of the whole of the community interest in such property is includible in determining the value of the decedent's gross estate under section 811 (whether or not a tax under chapter 3, relating to the estate tax, is payable upon the net estate of the decedent) and (ii) such part of the surviving spouse's one-half share of property held by the decedent and surviving spouse as community property as was included in computing the value of the decedent's gross estate if the death of the decedent was after October 21, 1942, and before January 1, 1948, and if a tax under chapter 3, relating to the estate tax, was payable upon the net estate of the decedent. Section 113 (a) (5) shall not, however, be applied in cases described in subdivision (ii) of this subparagraph so as to reduce the basis of any property below that which would exist without the application of such section.

(b) *Basis.* Section 113 (a) (5) provides three rules for determining the basis of property transmitted at death, first, a rule governing property generally, second, a special rule governing stock in a foreign personal holding company, and, third, a special rule applicable to both the first and second rules in certain cases where for estate tax purposes the decedent's gross estate is valued at the optional valuation dates.

(1) *General rule.* Except as prescribed in subparagraphs (2) and (3) of this paragraph, 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 Internal Revenue Code, 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.

(3) *Special rule where property valued at optional valuation dates.* Section 113 (a) (5) provides a special rule applicable in determining the basis of property described in subparagraphs (1) and (2) of this paragraph where—

(i) Such property is includible in the gross estate of a decedent who died after October 21, 1942, and

(ii) The executor elects for estate tax purposes under section 811 (j) to value the decedent's gross estate at the optional valuation dates prescribed in such section.

In such cases, the time of acquisition of such property for the purposes of subparagraphs (1) and (2) of this paragraph and the remainder of this section is considered to be the date at which such property is valued for estate tax purposes. Thus, in such cases, generally the basis will not be the value at the date of the decedent's death but (with certain limitations) the value at the date one year after his death or, in the case of such property distributed by the executor (or trustee, in certain cases) within one year after the decedent's death, the value as of the time of such distribution. See § 81.11 of this chapter (Regulations 105)

(c) *Fair market value.* For the purposes of this section, 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 the optional value as appraised for such purpose, whichever is applicable as provided in subparagraph (3) of paragraph (b) of this section, or if the estate is not subject to such tax, its value 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 acquisition.

(d) *Property acquired before March 1, 1913; reinvestments by fiduciary.* (1) 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)

(2) 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.* (1) 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,

(i) 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;

(ii) 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.

(2) 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.

(3) 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 section 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 section 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.

(g) *Joint and survivor annuities.* If, with respect to an annuitant who dies after December 31, 1950, the value of any part of a survivor's interest in a joint and survivor's annuity is required to be included in the gross estate of the deceased annuitant (whether or not such estate exceeds $60,000 so as to require the filing of an estate tax return under section 937) the basis of such interest to the survivor annuitant is considered to be the value at the time of the decedent's death. As to the taxability of survivor annuity payments in accordance with this rule, see § 39.22 (b) (2)-2.

§ 39.113 (a) (6) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; tax-free exchanges generally.*

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, or section 112 (l), the basis (except as provided in paragraphs (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) or section 112 (l) 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. Where as part of the consideration to the taxpayer another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for the purposes of this paragraph, be considered as money received by the taxpayer upon 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.

[Sec. 113 (a) (6) as amended by sec. 213 (d), Rev. Act 1939; sec. 121 (c) (1), (2), Rev. Act 1943]

§ 39.113 (a) (6)-1 *Property acquired upon a tax-free exchange.* (a) In the case of an exchange, after February 28, 1913, of property solely of the type described in section 112 (b) or (l) 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.

(b) (1) If, in an exchange, after February 28, 1913, of properties of the type indicated in section 112 (b) or (l) gain to the taxpayer was recognized under the provisions of section 112 (c) (d) or (l) 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.

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

Example. A purchased a share of stock in the X Corporation in 1935 for $100. Pursuant to a plan of reorganization, A in 1952 exchanged his share for one share in the Y Corporation, worth $90, and $30 in cash. A realized a gain of $20 upon the exchange, all of which is recognized under section 112 (c) (1). 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).

(c) (1) If, upon an exchange of properties of the type described in section 112 (b) or (l), 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) (d) or (l) 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.

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

Example. A purchased a share of stock in the X Corporation in 1933 for $100. Upon a reorganization of the X Corporation in 1952, 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. A realized a gain of $30 upon the exchange, all of which is recognized under section 112 (c) (1). 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 recognized ($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.

(d) Section 112 (e) 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) or (l) 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.

(e) Section 113 (a) (6) 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 section 113 (a) (7) and (8)

§ 39.113 (a) (6)-2 *Treatment of assumption of liabilities.* (a) For the purposes of section 113 (a) (6) the amount of any liabilities of the taxpayer assumed by the other party to the exchange is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption of liabilities resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made.

(b) The application of this section may be illustrated by the following examples:

Example (1). A, an individual, owns property having an adjusted basis of $100,000 and on which there is a purchase money mortgage of $25,000. On September 1, 1952, A organizes the X Corporation to which he transfers the property above described in exchange for all the capital stock of the X Corporation and the assumption of the $25,000 mortgage. The capital stock of the X Corporation has a fair market value of $150,000. Under section 112 (b) (5), no gain is recognized. The basis of such stock in A's hands is $75,000, computed as follows:

Adjusted basis of property transferred	$100,000
Less: Amount of money received (amount of liabilities assumed by X Corporation)	25,000
Basis of stock of the X Corporation in A's hands	75,000

Example (2). B, an individual, owns an apartment house which has an adjusted basis in his hands of $500,000, but which is subject to a mortgage of $150,000. On September 1, 1952, he transfers such apartment house to C, receiving in exchange therefor $50,000 in cash and another apartment house with a fair market value on that date of $600,000. The transfer to C is made subject to the $150,000 mortgage, but C does not assume such mortgage. B realizes a gain of $300,000 on the exchange, computed as follows:

Value of property received	$600,000
Cash	50,000
Liabilities subject to which old property was transferred	150,000
Total consideration received	800,000
Less: Adjusted basis of property transferred	500,000
Gain realized	300,000

Since section 112 (k) does not apply to section 112 (b) (1) or so much of section 112 (c) as relates to section 112 (b) (1), $200,000 of such $300,000 gain is recognized. The basis of the apartment house acquired by B upon the exchange is $500,000, computed as follows:

Adjusted basis of property transferred		$500,000
Less: Amount of money received:		
Cash	$50,000	
Amount of liabilities subject to which property was transferred	150,000	
		200,000
Difference		300,000
Plus: Amount of gain recognized upon the exchange		200,000
Basis of property acquired upon the exchange		500,000

§ 39.113 (a) (7) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; transfers to corporations.*

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.

§ 39.113 (a) (7)-1 *Property acquired by corporation in reorganization after December 31, 1917* (a) 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 (g) or a corresponding provision of a prior revenue act, 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 before 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.

(b) The application of the provisions of section 113 (a) (7) (A) may be illustrated by the following examples:

Example (1). In 1933 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 1933 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.

(c) 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 (g) or a corresponding provision of a prior revenue act, 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. The Y Corporation owns all of the stock of the X Corporation, which stock it acquired in 1952 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 1932 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 1952 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 1952 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.

§ 39.113 (a) (8) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired by issuance of stock or as paid-in surplus.*

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.

§ 39.113 (a) (8)-1 *Property acquired by a corporation after December 31, 1920.* (a) 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 section 113 (a) (7) 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 section 113 (a) (8), the limitations therein imposed upon the basis of such property are applicable.

(b) 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).

§ 39.113 (a) (9) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; involuntary conversions.*

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 the result of a compulsory or involuntary conversion, described in section 112 (f) (1) or (2), 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. This paragraph shall not apply in respect of property acquired as a result of a compulsory or involuntary conversion of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950. In the case of property purchased by the taxpayer which resulted, under the provisions of section 112 (f) (3), in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized; and if the property purchased consists of more than one piece of property, the basis determined under this sentence shall be allocated to the purchased properties in proportion to their respective costs.

[Sec. 113 (a) (9) as amended by sec. 2, Pub. Law 251 (82d Cong.); sec. 318 (b) (2), Rev. Act 1951]

§ 39.113 (a) (9)-1 *Property acquired as a result of an involuntary conversion.* (a) The provisions of the first sentence of section 113 (a) (9) may be illustrated by the following example:

Example. A vessel purchased by A in 1935 for $100,000 is destroyed in 1950 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.

(b) The provisions of the last sentence of section 113 (a) (9) may be illustrated by the following example:

Example. A taxpayer realizes $22,000 from the involuntary conversion of his barn in 1952; the adjusted basis of the barn to him was $10,000, and he spent in the same year $20,000 for a new barn which resulted in the nonrecognition of $10,000 of the $12,000 gain on the conversion. The unadjusted basis of the new barn to the taxpayer would be $10,000—the cost of the new barn ($20,000) less the amount of the gain not recognized on the conversion ($10,000). The unadjusted basis of the new barn would not be a substituted basis in the hands of the taxpayer within the meaning of section 113 (b) (2) (B). If the replacement of the converted barn had been made by the purchase of two smaller barns which, together, were similar or related in service or use to the converted barn and which cost $8,000 and $12,000, respectively, then the basis of the two barns would be $4,000 and $6,000, respectively, the cost of each barn ($8,000 and $12,000) less in each case the proportion of the gain not recognized on the conversion ($10,000) that the cost of each barn bears to the cost of both barns $\left(\frac{8,000}{20,000} \text{ and } \frac{12,000}{20,000}\right)$.

§ 39.113 (a) (10) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; wash sales of stock.*

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 chapter 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.

§ 39.113 (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 1935, which he sold January 15, 1952, for $80. On February 1, 1952, 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 1935, which he sold January 15, 1952, for $80. On February 1, 1952, 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).

§ 39.113 (a) (11) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired during affiliation.*

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 inter-company 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 chapter or the Revenue Act of 1928, 45 Stat. 831, or the Revenue Act of 1932, 47 Stat. 213, or the Revenue Act of 1934, 48 Stat. 720, or the Revenue Act of 1936, 49 Stat. 1698, or the Revenue Act of 1938, 52 Stat. 508, shall be determined in accordance with regulations prescribed under section 141 (b) of this chapter or the Revenue Act of 1928 or the Revenue Act of 1932 or the Revenue Act of 1934 or the Revenue Act of 1936 or the Revenue Act of 1938. 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 chapter or the Revenue Act of 1928 or the Revenue Act of 1932 or the Revenue Act of 1934 or the Revenue Act of 1936 or the Revenue Act of 1938, shall be adjusted in respect of any items relating to such period, in accordance with regulations prescribed under section 141 (b) of this chapter or the Revenue Act of 1928 or the Revenue Act of 1932 or the Revenue Act of 1934 or the Revenue Act of 1936 or the Revenue Act of 1938, applicable to such period.

[Sec. 113 (a) (11) as amended by sec. 2. Pub. Law 18 (77th Cong.)]

§ 39.113 (a) (11)-1 *Basis of property acquired during affiliation.* (a) (1) 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 section, 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.

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

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.

(b) 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 the regulations governing the making of 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 the regulations governing the making of consolidated returns, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

(c) Except as otherwise provided in Regulations 129 (Part 24 of this Chapter) the basis of property after a consolidated return period shall be the same as immediately prior to the close of such period.

§ 39.113 (a) (12) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; basis established by Revenue Act of 1932.*

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, 47 Stat. 199, was prescribed by section 113 (a) (6), (7), or (9) of such Act, then for the purposes of this chapter the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

§ 39.113 (a) (12)-1 *Basis of property established by Revenue Act of 1932.* (a) Section 113 (a) (12) provides that if the property was acquired, after February 28, 1913, in any taxable year beginning before 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 Internal Revenue Code the basis shall be the same as the basis prescribed in the Revenue Act of 1932.

(b) If, after December 31, 1923, and in any taxable year beginning before 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 § 39.22 (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.

(c) If 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 § 39.112 (g)-5.

§ 39.113 (a) (13) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired by or from partnerships.*

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.

§ 39.113 (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. For rules as to allocation of partnership income in the case of family partnerships, see section 191 and the regulations thereunder.

§ 39.113 (a) (13)-2 *Readjustment of partnership interests.* (a) 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 before 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 § 39.111-1. 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.

(b) 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.

(c) For rules as to allocation of partnership income in the case of family partnerships, see section 191 and the regulations thereunder.

§ 39.113 (a) (14) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired before 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—* * *

(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.

§ 39.113 (a) (14)-1 *Property acquired before March 1, 1913.* (a) The basis as of March 1, 1913, for determining gain in the case of property acquired before that date, is the basis otherwise provided for such property under section 113 (a) adjusted for the period before March 1, 1913, or the fair market value of the property as of March 1, 1913, whichever is higher.

(b) The basis as of March 1, 1913, for determining loss in the case of property acquired before 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. However, see sections 117 (k) (1) and 117 (k) (2) with respect to the determination of loss upon timber or coal which under the provisions of those sections is considered to be sold or exchanged.

(c) The application of section 113 (a) (14) may be illustrated by the following example:

Example. A, who makes his returns on the calendar year basis, purchased on March 1, 1903, property having a useful life of 50 years 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 before 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 property had a fair market value of $94,000, with a remaining life of 45 years. (i) For the purpose of determining gain from the sale or other disposition of the property on March 1, 1952, 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 March, 1952, is in the aggregate sum of $81,467, the adjusted basis for determining gain in 1952 is $12,533 ($94,000 less $81,467). (ii) For the purpose of determining a loss from the sale or other disposition of such

property in 1952, 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 before 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 $81,467, the aggregate amount of depreciation for which adjustment of such cost must be made is $91,467. The adjusted basis for determining the loss in 1952, is $8,533 ($100,000 less $91,467).

(d) 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.

§ 39.113 (a) (15) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property received by a corporation on complete liquidation of another*

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.

§ 39.113 (a) (15)-1 *Basis of property received by a corporation in complete liquidation of another corporation.* (a) Except as otherwise provided in this section, 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)

(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 § 3.113 (a) (15)-1 of Regulations 94 (26 CFR, 1938 ed.) 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.

§ 39.113 (a) (16) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; basis established by Revenue Act of 1934.*

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 chapter the basis shall be the same as the basis therein prescribed in the Revenue Act of 1934.

§ 39.113 (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 before 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 Internal Revenue Code 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 before 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 Code 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.

§ 39.113 (a) (17)-(18) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; cross reference; property received in certain corporate liquidations.*

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 the Securities and Exchange Commission.* If the property was acquired in a taxable year beginning before January 1, 1942, in any manner described in section 372 prior to its amendment by the Revenue Act of 1942, the basis shall be that prescribed in such section (prior to its amendment by such Act) with respect to such property. If the property was acquired in a taxable year beginning after December 31, 1941, in any manner described in section 372 (other than subsection (a) (2)) after its amendment by such Act, the basis shall be that prescribed in such section (after its amendment by such Act) with respect to such property.

[Sec. 113 (a) (17) as amended by sec. 171 (h), Rev. Act 1942]

(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) of this Chapter (whether before or after its amendment by any revenue act) or of the Revenue Act of 1938, 52 Stat. 487, 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.

[Sec. 113 (a) (18) as amended by sec. 120 (b), Rev. Act 1943; sec. 206 (b), Rev. Act 1950; sec. 316 (b), Rev. Act 1951]

§ 39.113 (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

(i) 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, or

(ii) Pursuant to a plan of liquidation adopted after February 25, 1944, 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 some one calendar month of the calendar year 1944; or

(iii) Pursuant to a plan of liquidation adopted after December 31, 1950, 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 some one calendar month of the calendar year 1951 or 1952; and

(3) In cancellation or redemption of only those shares of stock which were owned by such qualified electing shareholder at the time 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, if subdivision (i) of this subparagraph is applicable, or after December 10, 1943, if subdivision (ii) of this subparagraph is applicable, or after August 15, 1950, if subdivision (iii) of this subparagraph is applicable.

(b) *Basis.* (1) The basis of 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) of the Revenue Act of 1938, or section 112 (b) (7) of the Internal Revenue Code, as the case may be. 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.

(2) The application of subparagraph (1) 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 October, 1952, pursuant to the provisions of section 112 (b) (7) of the Internal Revenue Code. A, an individual and a qualified electing shareholder, received, in cancellation or redemption of 100 shares of stock owned by him at the time of the adoption of the plan of liquidation, $1,000 in cash, property (other than stock or securities acquired by the corporation after August 15, 1950) with a fair market value of $12,000, and stock acquired by the liquidating corporation after August 15, 1950, 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) of the Internal Revenue Code), was $2,500. His gain is $7,000, but under section 112 (b) (7) of the Internal Revenue Code 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 cancelled or redeemed	$10,000
Less money received	1,000
Remainder	9,000
Plus gain recognized	5,000
Basis of property acquired	14,000

The 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.

§ 39.113 (a) (19) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; stock dividends and stock rights.*

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—* * *

(19) (A) If the property was acquired by a shareholder in a corporation and consists of stock in such corporation, or rights to acquire such stock, acquired by him after February 28, 1913, in a distribution by such corporation (hereinafter in this paragraph called "new stock"), or consists of stock in respect of which such distribution was made (hereinafter in this paragraph called "old stock") and

(i) The new stock was acquired in a taxable year beginning before January 1, 1936; or

(ii) The new stock was acquired in a taxable year beginning after December 31, 1935, and its distribution did not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution;

then the basis of the new stock and of the old stock, respectively, shall, in the shareholder's hands, be determined by allocating between the old stock and the new stock the adjusted basis of the old stock; such allocation to be made under regulations which shall be prescribed by the Commissioner with the approval of the Secretary.

(B) Where the new stock consisted of rights to acquire stock and such rights were sold in a taxable year beginning before January 1, 1939, and there was included in the gross income for such year the entire amount of the proceeds of such sale, then, if before the date of the enactment of the Revenue Act of 1939 the taxpayer has not asserted (by claim for a refund or credit or otherwise) that any part of the proceeds of the sale of such new stock should be excluded from gross income for the year of its sale, the basis of the old stock shall be determined without regard to subparagraph (A); and no part of the proceeds of the sale of such new stock shall ever be excluded from the gross income of the year of such sale.

(C) Subparagraph (A) shall not apply if the new stock was acquired in a taxable year beginning before January 1, 1936, and there was included, as a dividend, in gross income for such year an amount on account of such stock, and after such inclusion such amount was not (before the date of the enactment of the Revenue Act of 1939) excluded from gross income for such year.

(D) Subparagraph (A) shall not apply if the new stock or the old stock was sold or otherwise disposed of in a taxable year beginning prior to January 1, 1936, and the basis (determined by a decision of a court or the Board of Tax Appeals, or a closing agreement, and the decision or agreement became final before the ninetieth day after the date of the enactment of the Revenue Act of 1939) for determining gain or loss on such sale or other disposition was ascertained by a method other than that of allocation of the basis of the old stock.

[Sec. 113 (a) (19) as added by sec. 214 (a), Rev. Act 1939]

§ 39.113 (a) (19)-1 *Basis of stock and rights involved in the acquisition of stock dividends or stock rights: general rules*—(a) *Stock dividends.* In the case of stock in respect of which was acquired a stock dividend of any character in a taxable year beginning before January 1, 1936, or in respect of which was acquired in a taxable year beginning after December 31, 1935, a stock dividend which did not constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution, the basis for determining gain or loss from a sale or other disposition of either the stock in respect of which the distribution was made or the stock dividend shall (except as otherwise prescribed in § 39.113 (a) (19)-2) be ascertained in accordance with the principles set forth in § 39.113 (a) (12)-1.

(b) *Stock rights acquired after December 31, 1924.* In the case of stock in respect of which were acquired after December 31, 1924, and before the first day of the first taxable year beginning after December 31, 1935, stock subscription rights (whether or not constituting income to the shareholder within the meaning of the sixteenth amendment to the Constitution) or in respect of which were acquired in a taxable year beginning after December 31, 1935, stock subscription rights which did not constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution, and in the case of such rights, the basis for determining gain or loss from a sale or other disposition of either the stock in respect of which the distribution was made, or the subscription rights distributed, or the stock acquired in the exercise of such rights shall (except as otherwise prescribed in § 39.113 (a) (19)-2) be ascertained in accordance with the principles set forth in § 39.22 (a)-8.

(c) *Stock rights acquired before January 1, 1925.* In the case of stock in respect of which were acquired before January 1, 1925, stock subscription rights (whether or not constituting income to the shareholder within the meaning of the sixteenth amendment to the Constitution) and in the case of such rights, the basis for determining gain or loss from a sale or other disposition of either the stock in respect of which the distribution was made, or the subscription rights distributed, or the stock acquired in the exercise of such rights shall (except as otherwise prescribed in § 39.113 (a) (19)-2) be ascertained in accordance with the principles set forth in article 39 of Regulations 65.

§ 39.113 (a) (19)-2 *Exceptions to general rules*—(a) *Proceeds of sale of rights reported as income.* In the case of stock rights sold in a taxable year beginning before January 1, 1939, the general rules for ascertaining the basis for determining gain or loss set forth in paragraphs (b) and (c) of § 39.113 (a) (19)-1, and in § 39.22 (a)-8 or article 39 of Regulations 65, as the case may be, shall not apply if the entire proceeds of such sale were included by the taxpayer as gross income for the year of the sale and if, before June 29, 1939, the taxpayer had not asserted by a claim for a refund or credit or otherwise that any part of such proceeds should not have been included in gross income for the year of the sale. In such cases, the basis for determining gain or loss from

a subsequent sale or other disposition of the stock in respect of which the rights were acquired shall be the same as though the rights had not been acquired.

(b) *Receipt of stock dividend or stock right reported as income in prior years.* In the case of stock dividends or stock rights acquired in a taxable year beginning before January 1, 1936, the general rules for ascertaining the basis for determining gain or loss set forth in §§ 39.113 (a) (19)-1, 39.113 (a) (12)-1, and 39.22 (a)-8, or article 39 of Regulations 65, as the case may be, shall not apply if for any reason there was included in the gross income of the shareholder as a dividend for such year, as, for example, pursuant to the provisions of section 201 (c) of the Revenue Act of 1918 or the corresponding provisions of prior revenue acts, or as a result of the decision of the Supreme Court in *Koshland* v. *Helvering* (298 U. S. 441) an amount reflecting the acquisition of such stock dividend or stock rights, and if before June 29, 1939, such amount was not excluded from gross income for such year. In such cases, the basis for determining gain or loss with respect to the old stock shall be the same as though the stock dividends or the stock rights had not been acquired, and the basis with respect to the stock dividend or stock right shall be an amount equal to that at which such stock dividend or stock right was included in gross income for the year of its acquisition.

(c) *Gain or loss upon sale of old or new stock finally determined upon basis inconsistent with general rules.* The general rules for ascertaining the basis for determining gain or loss set forth in § 39.113 (a) (19)-1 shall not apply with respect to the old stock, the new stock, or the subscription rights to acquire new stock, remaining on hand after a sale or other disposition of old stock, subscription rights, or new stock effected in a taxable year beginning before January 1, 1936, if the basis for determining gain or loss on such sale or other disposition was fixed by a decision of a court or The Tax Court of the United States or by a closing agreement, and if such decision or closing agreement became final before September 27, 1939, and if the basis for determining gain or loss upon such sale or other disposition was fixed by a method other than that of allocation of basis provided by the general rule. In such cases, the basis for determining gain or loss with respect to the remaining shares shall be fixed in a manner consistent with the prior determination to the end that, the sale or other disposition of all lots being considered, the taxpayer will have effected ultimately a tax-free recovery of the total cost or other basis of his original shares, and no more.

§ 39.113 (a) (20) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired by railroad corporation.*

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—* * *

(20) *Property acquired by railroad corporation.* If the property of a railroad corporation, as defined in section 77m of the National Bankruptcy Act, as amended, was acquired after December 31, 1938, in pursuance of an order of the court having jurisdiction of such corporation—

(A) In a receivership proceeding, or

(B) In a proceeding under section 77 of the National Bankruptcy Act, as amended,

and the acquiring corporation is a railroad corporation, as defined in section 77m of the National Bankruptcy Act, as amended, organized or made use of to effectuate a plan or [of] reorganization approved by the court in such proceeding, the basis shall be the same as it would be in the hands of the railroad corporation whose property was so acquired. The term "reorganization," as used in this paragraph, shall not be limited by the definition of such term in section 112 (g).

[Sec. 113 (a) (20) as added by sec. 142 (b), Rev. Act 1942; amended by sec. 126 (b), Rev. Act 1943]

§ 39.113 (a) (20)-1 *Property acquired by railroad corporation in a receivership or railroad reorganization proceeding.* (a) Section 113 (a) (20) sets forth certain conditions under which the basis of property acquired by a railroad corporation is the same as it would have been in the hands of the railroad corporation whose property was acquired. For the purpose of section 113 (a) (20) it is unnecessary that the acquisition in question be a direct transfer from the corporation undergoing reorganization or that such reorganization constitute a reorganization within the meaning of section 112 (g) It is sufficient if the acquisition is in pursuance of an order of the court and is an integral step in the consummation of a reorganization plan approved by the court having jurisdiction of the proceeding.

(b) If the conditions of section 113 (a) (20) are satisfied, then for the purpose of determining basis, the provisions of section 113 (a) (20) only shall apply, notwithstanding that the transaction might also fall within another provision of section 113 (a)

§ 39.113 (a) (21) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property property acquired by street, suburban, or interurban electric railway corporation.*

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—* * *

(21) *Property acquired by street, suburban, or interurban electric railway corporation.* If the property of any street, suburban, or interurban electric railway corporation engaged as a common carrier in the transportation of persons or property in interstate commerce was acquired after December 31, 1934, in pursuance of an order of the court having jurisdiction of such corporation in a proceeding under section 77B of the National Bankruptcy Act, as amended, and the acquiring corporation is a street, suburban, or interurban electric railway engaged as a common carrier in the transportation of persons or property in interstate commerce, organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, then, notwithstanding the provisions of section 270 of Chapter X of the National Bankruptcy Act, as amended, the basis, for any taxable year beginning after December 31, 1939, shall be the same as it would be in the hands of the corporation whose property was so acquired. The term "reorganization" as used in this paragraph, shall not be limited by the definition of such term in section 112 (g).

[Sec. 113 (a) (21) as added by sec. 142 (c), Rev. Act 1942]

§ 39.113 (a) (21)-1 *Property acquired by electric railway corporation in corporate reorganization proceeding.* Subject to the limitations and conditions set forth in section 113 (a) (21), if the reorganization under section 77B of the Bankruptcy Act, 48 Stat. 912, of an electric railway corporation results in the acquisition of the property of such corporation by another corporate entity, the basis of such property in the hands of the acquiring corporation is the same as it would be in the hands of the old corporation. It is requisite to the application of the section that both corporations be street, suburban, or interurban electric railway corporations engaged in the transportation of persons or property in interstate commerce, and that the acquisition is in pursuance of an order of the court and is an integral step in the consummation of a reorganization plan approved by the court having jurisdiction of the proceeding. If section 113 (a) (21) applies, section 270 of the Bankruptcy Act (11 U. S. C. 670), relating to the adjustment of basis by reason of the cancellation or reduction of indebtedness in a corporate reorganization proceeding, is inapplicable. Moreover, if the transaction is within the provisions of section 113 (a) (21) and may also be considered to be within any other provision of section 113 (a), then the provisions of section 113 (a) (21) only shall apply.

§ 39.113 (a) (22) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; property acquired on reorganization of certain corporations.*

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—* * *

(22) *Property acquired on reorganization of certain corporations.* If the property was acquired by a corporation upon a transfer to which section 112 (b) (10), or so much of section 112 (d) or (e) as relates to section 112 (b) (10), is applicable, then, notwithstanding the provisions of section 270 of the National Bankruptcy Act, as amended, the basis in the hands of the acquiring corporation shall be the same as it would be in the hands of the corporation whose property was so acquired, increased in the amount of gain recognized to the corporation whose property was so acquired under the law applicable to the year in which the acquisition occurred, and such basis shall not be adjusted under subsection (b) (3) by reason of a discharge of indebtedness pursuant to the plan of reorganization under which such transfer was made.

[Sec. 113 (a) (22) as added by sec. 121 (c) (3), Rev. Act 1943]

§ 39.113 (a) (22)-1 *Basis of property acquired by corporation as result of certain corporate reorganization or receivership proceedings.* (a) If, as the result of a transaction described in section 112

(b) (10) or so much of section 112 (d) or (e) as relates thereto, the property of an insolvent corporation is transferred, in pursuance of a plan of reorganization, to a corporation organized or made use of to effectuate such plan, the basis of such property in the hands of the acquiring corporation is the same as it would be in the hands of the insolvent corporation, increased in the amount of gain recognized upon such transfer under the law applicable to the year in which the transfer was made. In any such case, the adjustments to basis provided by section 270 of the Bankruptcy Act (11 U. S. C. 670) or section 113 (b) (3) of the Internal Revenue Code, shall not be made in respect of any indebtedness canceled pursuant to the plan of reorganization under which the transfer was made. If the transaction falls within the provisions of section 113 (a) (22) the basis of the property involved shall be determined pursuant to such provisions, notwithstanding that the transaction might otherwise fall within another provision of section 113 (a)

(b) The provisions of section 113 (a) (22) are applicable in the determination of basis for all taxable years beginning after December 31, 1933, except that the basis so determined shall not be given effect in the determination of the tax liability for any taxable year beginning January 1, 1943. With the exception indicated, the basis so prescribed is applicable from the date of acquisition of such property. For example, the provisions of section 113 (b) relating to adjusted basis shall be applied as if section 113 (a) (22) were a part of the Internal Revenue Code and prior internal revenue laws applicable to all taxable years beginning after December 31, 1933. Hence, in determining the amount of the adjustments for depreciation, depletion, etc., under the provisions of section 113 (b) (1) (B) the "amount allowable" is the amount computed with reference to the basis provided in section 113 (a) (22)

(c) The effect of the application of section 113 (a) (22) may be illustrated by the following examples:

Example (1). On January 1, 1935, the Y Corporation, a taxpayer making its returns on the calendar year basis, acquired depreciable property from the X Corporation as the result of a transaction described in section 113 (a) (22). On January 1, 1935, the property had, in the hands of the X Corporation, a basis of $200,000, an adjusted basis of $150,000, a fair market value as of January 1, 1935, of $80,000, and an estimated remaining life of 20 years. The 1935 transaction was treated as a taxable exchange and, accordingly, the Y Corporation claimed and was allowed depreciation in the amount of $4,000 for each of the eight taxable years 1935 through 1942, inclusive. For each of the nine taxable years 1943 through 1951, inclusive, the Y Corporation claimed and was allowed depreciation in the amount of $7,500. On June 30, 1952, the property was sold for $10,000, cash. The amount of the loss sustained upon the sale is computed as follows:

Basis to X Corporation		$200,000
Adjustment for depreciation in the hands of X Corporation (sec. 113 (b))		50,000
Adjusted basis for depreciation in the hands of both X and Y Corporations (sec. 113 (a) (22))		$150,000
Deduct:		
Depreciation allowable in amount of $7,500 per year (1/20 of $150,000) for 8 years, from Jan. 1, 1935, through Dec. 31, 1942	$60,000	
Depreciation allowable Jan. 1, 1943, to June 30, 1952 (9½ years at $7,500)	71,250	
		131,250
Adjusted basis for computing gain or loss		18,750
Sale price		10,000
Loss sustained		8,750

For the taxable year 1943 and succeeding taxable years, the Y Corporation is entitled to deductions for depreciation in respect of such property in the amounts of $7,500 in the determination of its tax liabilities for such years. But no change in the tax liability is authorized for preceding taxable years by reason of the difference between the $7,500 depreciation allowable and the $4,000 deduction previously allowed.

Example (2). Assume the same facts as in example (1), except that the property acquired by the Y Corporation had a fair market value as of January 1, 1935, of $180,000, instead of $80,000, and that the Y Corporation claimed and was allowed depreciation in the amount of $9,000 for each of the eight taxable years 1935 to 1942, inclusive, and in the amount of $6,500 for the taxable years 1943 to 1951, inclusive. In such case, the amount of the loss sustained upon the sale of the property would be computed as follows:

Adjusted basis for depreciation in the hands of Y Corporation as computed in example (1)		$150,000
Deduct:		
Depreciation allowed in the amount of $9,000 per year for 8 years, Jan. 1, 1935, to Dec. 31, 1942	$72,000	
Depreciation allowable Jan. 1, 1943, to June 30, 1952, inclusive (9½ times $6,500)	61,750	
		133,750
Adjusted basis for computing gain or loss		16,250
Sale price		10,000
Loss sustained		6,250

No change in the tax liability is authorized for taxable years preceding 1943 by reason of the difference between the $7,500 depreciation allowable and the $9,000 deduction previously allowed.

§ 39.113 (a) (23) *Statutory provisions; adjusted basis for determining gain or loss; basis (unadjusted) of property; stock acquired in tax-free distributions.*

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— * * *

(23) *Tax-free distributions*. If the property consists of stock distributed after the date of the enactment of the Revenue Act of 1951 to a taxpayer in connection with a transaction described in section 112 (b) (11) (hereinafter in this paragraph called "new stock"), or consists of stock in respect of which such distribution was made (hereinafter in this paragraph called "old stock"), then the basis of the new stock and of the old stock, respectively, shall, in the shareholder's hands, be determined by allocating between the old stock and the new stock the adjusted basis of the old stock; such allocation to be made under regulations prescribed by the Secretary.

[Sec. 113 (a) (23) as added by sec. 317 (b), Rev. Act 1951]

§ 39.113 (a) (23)-1 *Basis of stock on certain distributions on reorganization*. The distribution, in pursuance of a plan of reorganization, to a shareholder of a corporation (a party to the reorganization) of stock in another corporation (also a party to the reorganization) may be within the provisions of section 112 (g) of the Revenue Act of 1932, or the corresponding provisions of prior revenue laws, if made before January 1, 1934, or may be within the provisions of section 112 (b) (11) if made after October 20, 1951, and if the distribution consists of stock other than preferred stock. Section 112 (g) of the Revenue Act of 1932 and section 112 (b) (11) provide that no gain shall be recognized to the shareholder in the case of such distribution. The basis of the stock in respect of which the distribution was made and of the stock distributed to the shareholder is ascertained in accordance with the principles set forth in § 39.113 (a) (12)-1 in the case of such a distribution made before January 1, 1934. The same principles of § 39.113 (a) (12)-1 shall apply to the determination of the basis of such stock in the case of a distribution after October 20, 1951, to which section 112 (b) (11) is applicable.

§ 39.113 (b) (1) *Statutory provisions; adjusted basis for determining gain or loss; general rule.*

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, but no such adjustment shall be made for taxes or other carrying charges, or for expenditures described in section 23 (bb), 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 of the amount—

(i) Allowed as deductions in computing net income under this chapter or prior income tax laws, and

(ii) Resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this chapter (other than subchapter E), subchapter E of chapter 2, or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this chapter or prior income tax laws. Clause (ii) of this subparagraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under subsection (d).

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, Feb. 24, 1919, c. 18, 40 Stat. 1057, or the Revenue Act of 1921, Nov. 23, 1921, c. 136, 42 Stat. 227, 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.

(G) In the case of property pledged to the Commodity Credit Corporation, to the extent of the amount received as a loan from the Commodity Credit Corporation and treated by the taxpayer as income for the year in which received pursuant to section 123 of this chapter, and to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability.

(H) In the case of any bond (as defined in section 125) the interest on which is wholly exempt from the tax imposed by this chapter, to the extent of the amortizable bond premium disallowable as a deduction pursuant to section 125 (a) (2), and in the case of any other bond (as defined in such section) to the extent of the deductions allowable pursuant to section 125 (a) (1) with respect thereto.

(I) In the case of any short-term municipal bond (as defined in section 22 (o)), to the extent provided in section 22 (o) (1) (B).

(J) For amounts allowed as deductions as deferred expenses under section 23 (cc) (2) (relating to certain expenditures in the development of mines) and resulting in a reduction of the taxpayer's taxes under this chapter, but not less than the amounts allowable under such section for the taxable year and prior years.

(K) In the case of a residence the acquisition of which resulted, under the provisions of section 112 (n), in the nonrecognition of any part of the gain realized upon the sale, exchange, or involuntary conversion of another residence, to the extent provided in section 112 (n) (4).

(L) For deductions to the extent disallowed under section 24 (f), notwithstanding the provisions of any other subparagraph of this paragraph.

(M) For amounts allowed as deductions as deferred expenses under section 23 (ff) (2) (relating to certain exploration expenditures) and resulting in a reduction of the taxpayer's taxes under this chapter, but not less than the amounts allowable under such section for the taxable year and prior years.

[Sec. 113 (b) (1) as amended by sec. 223 (b), Rev. Act 1939; secs. 126 (c), 130 (b), Rev. Act 1942; secs. 203 (b) (1), 204 (b), Rev. Act 1950; secs. 309 (b), 318 (b) (3), 323 (b) (2), 342 (b), Rev. Act 1951; sec. 1, Pub. Law 539 (82d Cong.)]

§ 39.113 (b) (1)-1 *Adjusted basis*—(a) *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 section 113 (a) (1) to (23) inclusive, the basis therein provided, adjusted to the extent provided in section 113 (b)

(b) *Items properly chargeable to capital account.* (1) 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: (i) Expenditures made in the taxable year 1932 or subsequent taxable years which are allowable under article 235 or 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 (26 CFR, 1938 ed., Part 3) article 23 (m)-15 or 23 (m)-16 of Regulations 101 (26 CFR, 1938 ed., Part 9) § 19.23 (m)-15 or § 19.23 (m)-16 of Regulations 103 (26 CFR, 1938 ed., Supps.) § 29.23 (m)-15 or § 29.23 (m)-16 of Regulations 111 (26 CFR, 1949 ed., Supps.) and § 39.23 (m)-15 or § 39.23 (m)-16 as deductions in computing net income; (ii) 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.

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

Example. A, who makes his returns on the calendar year basis, purchased property in 1941 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 1952 for $20,000, the amount of his gain will be $4,000.

(3) Capital expenditures and carrying charges with respect to property (whether real or personal, improved or unimproved, and whether productive or unproductive) such as taxes and interest, which the taxpayer may elect to treat either as chargeable to capital account or, in the manner provided in § 39.24 (a)-6 (c) as an allowable deduction, but for which deductions have not been taken for any taxable year, are properly chargeable to capital account. The term "taxes" for this purpose includes duties and excise taxes (see § 39.23 (c)-2) but does not include income taxes.

(4) Expenditures to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical, described in section 23 (bb) are chargeable to capital account only in accordance with and in the manner provided in § 39.23 (bb)-1.

(c) *Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913*—(1) *In general.* (i) The cost or other basis must be decreased, to the extent provided in subparagraphs (2), (3), and (4) of this paragraph, by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion. The adjustment required for any taxable year or period is the amount allowed (or the portion thereof referred to in subparagraph (2) (i) or subparagraph (4) (i) of this paragraph, as the case may be) 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.

(ii) 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, the Revenue Act of 1938, and the Internal Revenue Code, for the taxable year 1932 and subsequent taxable years, but the amount of the diminution in respect of depletion for taxable years before 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.

(2) *Adjustment for periods beginning on or after January 1, 1952.* The decrease required by subparagraph (1) of this paragraph for deductions in respect of any period beginning on or after January 1, 1952, shall be whichever is the greater of the following amounts:

(i) The amount allowed as deductions in computing net income under chapter 1 and resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under chapter 1 (other than subchapter E, relating to the tax on self-employment income),

(ii) The amount properly allowable as deductions in computing net income under chapter 1 (whether or not the amount properly allowable would have caused a reduction for any taxable year of the taxpayer's taxes)

(3) *Adjustment for periods since February 28, 1913, and before January 1, 1952, where no election made.* Except where an election has been properly made under section 113 (d) (see subparagraph (4) of this paragraph), the decrease required by paragraph (1) for deductions in respect of any period since February 28, 1913, and before January 1, 1952, shall be whichever of the following amounts is the greater:

(i) The amount allowed as deductions in computing net income under chapter 1 or prior income tax laws;

(ii) The amount properly allowable in computing net income under chapter 1 or prior income tax laws.

For the purpose of determining the decrease required by this subparagraph it is immaterial whether or not the amount under subdivision (i) of this subparagraph or the amount under subdivision (ii) of this subparagraph would have resulted in a reduction for any taxable year of the taxpayer's taxes.

(4) *Adjustment for period since February 28, 1913, and before January 1, 1952, where election made under section 113 (d).* If an election has been properly made under section 113 (d) (see § 39.113 (d)-1) the decrease required by subparagraph (1) of this paragraph for deductions in respect of any period since February 28, 1913, and before January 1, 1952, shall be whichever is the greater of the following amounts:

(i) The amount allowed as deductions in computing net income under chapter 1 or prior income tax laws and resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under chapter 1 (other than subchapter E, relating to the tax on self-employment income) subchapter E of chapter 2, or prior income, war-profits, or excess-profits tax laws;

(ii) The amount properly allowable as deductions in computing net income under chapter 1 or prior income tax laws (whether or not the amount properly allowable would have caused a reduction for any taxable year of the taxpayer's taxes)

(5) *Determination of amount allowed which reduced taxpayer's taxes.* (i) For the purpose of determining whether the amount allowed which resulted in a reduction for any taxable year of the taxpayer's taxes under chapter 1 of the Internal Revenue Code (other than subchapter E) subchapter E of chapter 2, or prior income, war-profits, or excess-profits tax laws, which amount is hereinafter referred to as the "tax-benefit amount allowed," exceeded the amount allowable, a determination must be made of that portion of the excess of the amount allowed over the amount allowable which, if disallowed, would not have resulted in an increase in any such tax previously determined. If the entire excess of the amount allowed over the amount allowable could be disallowed without any such increase in tax, the tax-benefit amount allowed shall not be considered to have exceeded the amount allowable. If only part of such excess could be disallowed without any such increase in tax, the tax-benefit amount allowed shall be considered to exceed the amount allowable to the extent of the remainder of such excess.

(ii) For this purpose, the tax previously determined shall be determined under the principles of section 3801 (d) the only adjustments made in determining whether there would be an increase in tax shall be those resulting from the disallowance of the amount allowed. The taxable years for which the determination is made shall be the taxable year for which the deduction was allowed and any other taxable year which would be affected by the disallowance of such deduction. Examples of such other taxable years are taxable years to which there was a carry-over or carry-back of a net operating loss or an unused excess-profits credit from the taxable year for which the deduction for depreciation, etc., was allowed, and taxable years for which a computation under section 22 (b) (12) or section 127 was made by reference to the taxable year for which the deduction was allowed. In determining whether the disallowance of any part of the deduction for depreciation, etc., would not have resulted in an increase in any tax previously determined, proper adjustment must be made for previous determinations under section 452, 734, or 3801, and for any previous application of section 113 (b) (1) (B) (ii).

(iii) If a determination under section 113 (b) (1) (B) (ii) must be made with respect to several properties for each of which the amount allowed for the taxable year exceeded the amount allowable, the tax-benefit amount allowed with respect to each of such properties shall be an allocated portion of the tax-benefit amount allowed determined by reference to the sum of the amounts allowed and the sum of the amounts allowable with respect to such several properties.

(iv) In the case of property held by a partnership or trust, the computation of the tax-benefit amount allowed shall take into account the tax benefit of the partners or beneficiaries, as the case may be, from the deduction by the partnership or trust of the amount allowed to the partnership or the trust. For this purpose, the determination of the amount allowed which resulted in a tax benefit to the partners or beneficiaries shall be made in the same manner as that provided above with respect to the taxes of the person holding the property.

(v) A taxpayer seeking to limit the adjustment to basis to the tax-benefit amount allowed for any period, in lieu of the amount allowed, must establish the tax-benefit amount allowed. A failure of adequate proof as to the tax-benefit amount allowed with respect to one period does not preclude the taxpayer from limiting the adjustment to basis to the tax-benefit amount allowed with respect to another period for which adequate proof is available. For example, a corporate transferee may have available adequate records with respect to the tax effect of the deduction for the taxable years 1946 and 1947 of erroneous depreciation, but may not have available adequate records with respect to the deduction of excessive depreciation for a prior period during which the property was held by its transferor. In such case, assuming a proper election is made under section 113 (d), the corporate transferee shall not be denied the right to apply this section with respect to the erroneous depreciation for the period for which adequate proof is available.

(6) *Determination of amount allowable in prior taxable years.* (i) Under section 113 (b) (1) (B), one of the factors involved in determining the adjustment to basis as of any date is the amount allowable for periods prior to such date. The amount allowable for such prior periods is determined under the law applicable to such prior periods; all adjustments required by the law applicable to such periods are made in determining the adjusted basis of the property for the purpose of determining the amount allowable. Since provisions corresponding to the amendment to section 113 (b) (1) (B) made by Public Law 539 (82d Congress) are deemed included in all revenue laws applicable to taxable years ending after December 31, 1931, the amount allowable for any such taxable year must be computed with the application of such provisions. For example, if the adjusted basis of property is determined as of January 1, 1952, if an election was properly made under section 113 (d) and if the property was held since January 1, 1930, then the amount allowable which is taken into account in computing the adjusted basis as of January 1, 1952, shall be determined for all taxable years ending after December 31, 1931, with the application to each such taxable year of the provisions of section 113 (b) (1) (B) as amended by Public Law 539. Public Law 539 made no change in the law applicable in determining the amount allowable for taxable years ending before January 1, 1932. In any case in which, prior to the enactment of Public Law 539 (July 14, 1952) there was a final decision of a court determining the amount allowable for a particular taxable year, such determination (but only for the purpose of determining the adjustment under section 113 (b) (1) (B) by reference to such allowable amount) must be adjusted to the extent necessary to reflect the amendment made by Public Law 539 to the law applicable to the taxable year for which the amount was allowable.

(ii) Although Public Law 539 amends the law applicable to all taxable years ending after December 31, 1931, the amendment does not open for refund, credit, or assessment of a deficiency any taxable year for which such refund, credit, or assessment is barred by any law or rule of law.

(7) *Property with transferred basis.* The following rules apply in the determination of the adjustments to basis of property in the hands of a transferee, donee, or grantee which are required by section 113 (b) (2) with respect to the period the property was held by the transferor, donor, or grantor:

(i) An election under section 113 (d) by a transferor, donor, or grantor made after the date of the transfer, gift, or grant of the property shall not affect the basis of such property in the hands of the transferee, donee, or grantee. Such an election made before the date of the transfer must be taken into account in determining under section 113 (b) (2) the adjustments to basis as of the date of the transfer, gift, or grant, whether or not an election under section 113 (d) was made by the transferee, donee, or grantee.

(ii) An election by the transferee, donee, or grantee shall be applicable in determining the adjustments to basis for the period during which the property was held by the transferor, donor, or grantor, whether or not the transferor, donor, or grantor had made an election, provided that the property was held by the transferee, donee, or grantee at any time on or before the date on which his election was made.

(8) The application of this paragraph may be illustrated by the following examples:

Example (*1*). The case of Corporation A discloses the following facts:

(1) Year	(2) Amount allowed	(3) Amount allowed which reduced taxpayer's taxes	(4) Amount allowable	(5) Amount allowable but not less than amount allowed	(6) Amount allowable but not less than amount allowed which reduced taxpayer's taxes
1949	$6,000	$5,500	$5,000	$6,000	$5,500
1950	7,000	7,000	6,500	7,000	7,000
1951	5,000	4,000	6,500	6,500	6,500
Total, 1949-51				19,500	19,000
1952	6,500	6,500	6,000		6,500
1953	5,000	4,000	4,000		4,000
1954	4,500	4,500	6,000		6,000
Total, 1952-54					16,500

The cost or other basis is to be adjusted by $16,500 with respect to the years 1952-1954, that is, by the amount allowable but not less than the amount allowed which reduced the taxpayer's taxes. An adjustment must also be made with respect to the years 1949-1951, the amount of such adjustment depending upon whether an election was properly made under section 113 (d). If no such election was made, the amount of the adjustment with respect to the years 1949-1951 is $19,500, that is, the amount allowed but not less than the amount allowable. If an election was properly made, the amount of the adjustment with respect to the years 1949-1951 is $19,000, that is, the amount allowable but not less than the amount allowed which reduced the taxpayer's taxes.

Example (*2*). Corporation A purchased a building on January 1, 1950, at a cost of $100,000. On the basis of the facts reasonably known to exist at the end of 1950, a period of 50 years should have been used as the correct useful life of the building; nevertheless, depreciation was computed by Corporation A on the basis of a useful life of 25 years, and was allowed for 1950 through 1953 as a deduction in an annual amount of $4,000. The building was sold on January 1, 1954. Corporation A did not make an election under section 113 (d). No part of the amount allowed Corporation A for any of the years 1950 through 1953 resulted in a reduction of Corporation A's taxes. The adjusted basis of the building as of January 1, 1954, is $88,166, computed as follows:

Year	Adjustments to basis as of beginning of taxable year	Adjusted basis	Remaining life	Depreciation allowable	Depreciation allowed
1950		$100,000	50	$2,000	$4,000
1951	$4,000	96,000	49	1,959	4,000
1952	8,000	92,000	48	1,917	4,000
1953	9,917	90,083	47	1,917	4,000
1954	11,834	88,166			

Example (*3*). The facts are the same as in Example (2), except that Corporation A made a proper election under section 113 (d). In such case, the adjusted basis of the building as of January 1, 1954, is $92,000, computed as follows:

Year	Adjustments to basis as of beginning of taxable year	Adjusted basis	Remaining life	Depreciation allowable	Depreciation allowed
1950		$100,000	50	$2,000	$4,000
1951	$2,000	98,000	49	2,000	4,000
1952	4,000	96,000	48	2,000	4,000
1953	6,000	94,000	47	2,000	4,000
1954	8,000	92,000			

Example (*4*). If it is assumed that in Example (2), or in Example (3), all of the deduction allowed Corporation A for 1953 had resulted in a reduction of A's taxes, the adjustment to the basis of the building for depreciation for 1953 would reflect the entire $4,000 deduction. In such case, the adjusted basis of the building as of January 1, 1954, would be $86,083 in Example (2), and $90,000 in Example (3).

Example (*5*). The facts are the same as in Example (2) except that for the year 1950 all of the $4,000 amount allowed Corporation A as a deduction for depreciation for that year resulted in a reduction of A's taxes. In such case, the adjustments to the basis of the building remain the same as those set forth in Example (2).

Example (*6*). The facts are the same as in Example (3) except that for the year 1950 all of the $4,000 amount allowed Corporation A as a deduction for depreciation resulted in a reduction of A's taxes. In such case, the adjusted basis of the building as of January 1, 1954, is $90,123, computed as follows:

Year	Adjustments to basis as of beginning of taxable year	Adjusted basis	Remaining life	Depreciation allowable	Depreciation allowed
1950		$100,000	50	$2,000	$4,000
1951	$4,000	96,000	49	1,959	4,000
1952	5,959	94,041	48	1,959	4,000
1953	7,918	92,082	47	1,959	4,000
1954	9,877	90,123			

(d) *Exhaustion, wear and tear obsolescence, amortization, and depletion, periods prior to March 1, 1913.* 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.

(e) *Certain stock distributions.* (1) 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)

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

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 before March 1, 1913. The adjusted basis for determining the gain or loss from the sale or other disposition of the stock in 1952 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.

(f) *Stock of United States shareholders of a foreign personal holding company.* In the case of the stock of the 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)

(g) *Other applicable rules.* (1) 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.

(2) In determining basis, and adjustments to basis, the principles of estoppel apply, as elsewhere under the Internal Revenue Code.

(3) For adjustment to basis of bonds on account of amortizable bond premium, see §§ 39.125 (a)-1 to 39.125 (c)-2, inclusive. For adjustment to basis of short-term municipal bonds as defined in section 22 (o) (2) (A), see § 39.22 (o)-1.

(4) For adjustment to basis on account of expenditures attributable to a grant or loan made to a taxpayer by the United States for the encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, see section 22 (b) (15) and § 39.22 (b) (15-1.

(5) With respect to taxable years ending after December 31, 1950, the basis shall also be adjusted to take into account the amount of expenditures for development and exploration of mines or mineral deposits treated as deferred expenses under section 23 (cc) (2) and (ff) (2) The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions under such sections which results in a reduction of the taxpayer's liability for income

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tax but not less than the amounts allowable under such sections for the taxable year and prior years. For example, if a taxpayer purchases unexplored and undeveloped mining property for $1,000,000 and at the close of the development stage has incurred exploration and development costs of $9,000,000 treated as deferred expenses, the basis of such property at such time for computing gain or loss will be $10,000,000. Assuming that the taxpayer in this example has operated the mine for several years and has deducted allowable percentage depletion in the amount of $2,000,000 and has deducted allowable deferred exploration and development expenditures of $2,000,000, the basis of the property in the taxpayer's hands for purposes of determining gain or loss if sold will be $6,000,000.

(6) In the case of an unharvested crop which is sold, exchanged, or involuntarily converted with the land and which is considered as property used in the trade or business under section 117 (j) (3) the basis of such crop shall be increased by the amount of the items which are attributable to the production of such crop and which are disallowed, under section 24 (f) and § 39.24 (f)-1, as deductions in computing net income. See also § 39.117 (j)-1. The basis of any other property shall be decreased by the amount of any such items which are attributable to such other property, notwithstanding any provision of section 113 (b) (1) or of this section to the contrary. For example, if the items attributable to the production of an unharvested crop consist only of fertilizer costing $100 and $50 depreciation on a tractor used only to cultivate such crop and such items are disallowed under section 24 (f) and § 39.24 (f)-1, the adjustments to the basis of such crop shall include an increase of $150 for such items and the adjustments to the basis of the tractor shall include a reduction of $50 for the depreciation on the tractor.

(7) For the adjustments to basis of a residence because its acquisition resulted, under the provisions of section 112 (n) in the nonrecognition of any part of the gain realized upon the sale, exchange, or involuntary conversion of another residence, see § 39.112 (n)-1.

§ 39.113 (b) (1)-2 *Adjusted basis; cancellation of indebtedness.* (a) In addition to the adjustments provided in section 113 (b) (1) and § 39.113 (b) (1)-1 which are required to be made with respect to the cost or other basis of property, a further adjustment is required in certain cases in which there has been a cancellation or reduction of indebtedness in a proceeding under the Bankruptcy Act (11 U. S. C. 1 et seq.) Except as otherwise provided in section 113 (a) (21) or (22) or 113 (b) (4) such 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 section 606 (8) of the Bankruptcy Act (11 U. S. C. 1006 (8)) or 77B, 48 Stat. 912, or under Chapter X, XI, or XII of the Bankruptcy Act (11 U. S. C. c. 10, 11, and 12) 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 not below its fair market value) 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 not below its fair market value) 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 subparagraphs (1) and (2) of this paragraph 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 such subparagraphs) as follows: The cost or other basis of each unit of property shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the adjusted basis (after adjustment under subparagraphs (1) and (2) of this paragraph) of each such unit of property bears to the sum of the adjusted bases (after adjustment under such subparagraphs) of all the property of the debtor other than inventory and notes and accounts receivable;

(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 subparagraphs (1) (2), and (3) of this paragraph shall next be applied to reduce the cost of other basis of any units of property covered by such subparagraphs which have a remaining basis (after adjustment under such subparagraphs) greater than their fair market value, as follows: The cost or other basis of each such unit of property shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the remaining basis of each such unit bears to the sum of the remaining bases of such units. The process shall be repeated until the cost or other basis of each unit of the property covered by subparagraphs (1), (2), and (3) of this paragraph is reduced to its fair market value or the amount by which the indebtedness shall have been canceled or reduced is exhausted, taking into account in the successive steps only those units of property having, after the preceding adjustment, a remaining basis greater than their fair market value; and

(5) Any excess of the total amount by which the indebtedness shall have been so canceled or reduced over the sum of the adjustments made under subparagraphs (1) (2) (3), and (4) of this paragraph 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 not below its fair market value) 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. The process shall be repeated until the adjusted bases of inventory, notes receivable and accounts receivable are reduced to their fair market value or the amount by which the indebtedness shall have been canceled or reduced is exhausted, taking into account in the successive steps only those units of property having, after the preceding adjustment, a remaining basis greater than their fair market value.

(b) For the purposes of this section:

(1) Basis shall be determined as of the date of entry of the order confirming the plan, composition, or arrangement under which such indebtedness shall have been canceled or reduced;

(2) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(3) No adjustment shall be made by virtue of the cancellation or reduction of any accrued interest unpaid which shall not have resulted in a tax benefit in any income tax return;

(4) 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 and

(5) The term "fair market value" has reference to such value as of the date of entry of the order confirming the plan, composition, or arrangement under which such indebtedness shall have been canceled or reduced.

(c) Any determination of value in a proceeding under the Bankruptcy Act (11 U. S. C. 1 et seq.) shall not constitute a determination of fair market value for the purposes of this section.

(d) 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 section.

§ 39.113 (b) (1)-3 *Adjusted basis; cancellation of indebtedness; special cases.* If the taxpayer and the Commissioner agree, the basis of the taxpayer's property may be adjusted in a manner different from that set forth in § 39.113 (b) (1)-2. Variations from such rule may, for example, involve adjusting the basis of any part of the taxpayer's prop-

erty or adjusting the basis of all the taxpayer's property, according to a fixed allocation. Agreement between the taxpayer and the Commissioner as to any variation from such general rule shall be effected only by a closing agreement entered into under the provisions of section 3760.

§ 39.113 (b) (1)-4 *Adjusted basis; mutual savings banks, building and loan associations, and cooperative banks.* (a) The adjustments to the cost or other basis of property provided in section 113 (b) and §§ 39.113 (b) (1)-1 to 39.113 (b) (1)-3, inclusive, are applicable in the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit, although such institutions were exempt from tax for taxable years beginning before January 1, 1952. Proper adjustment must be made under section 113 (b) for the entire period since the acquisition of property. Thus, adjustment to basis must be made for depreciation allowable for all prior taxable years although such institution may have been exempt from tax during such period. Similarly, in the case of tax exempt and partially taxable bonds purchased at a premium and subject to amortization under section 125, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example: On January 1, 1952, Z, a mutual savings bank, which keeps its books on a calendar year basis, owns a tax-exempt $1,000 noncallable bond maturing on January 1, 1962. Such bond was acquired by Z on January 1, 1932, for $1,300. It was sold by Z on December 31, 1952, for $1,250. The yearly rate of amortization of the premium, determined by dividing the total premium of $300 by the life of the bond (30 years) is $10. Z realizes a gain of $60 from such sale computed as follows:

(1) Cost of bond		$1,300
(2) Amount of bond premium attributable to years 1942 through 1951, during which Z was exempt from tax ($10 times 10 years)	$100	
(3) Amount of bond premium amortized from Jan. 1, 1952, through Dec. 31, 1952 ($10 times 1 year)	10	
(4) Total amount of adjustments to basis (aggregate of (2) and (3))		110
(5) Adjusted basis of bond at close of 1952 ((1) reduced by (4))		1,190
(6) Gain realized upon sale—excess of sale price over adjusted basis ($1,250 minus $1,190)		60

The basis of a fully taxable bond purchased at a premium shall be adjusted from the date of the election to amortize such premium in accordance with the provisions of section 125, except that no adjustment shall be allowable for such portion of the premium, attributable to the period prior to the election.

(c) In the case of a mortgage purchased, acquired, or originated at a premium, where the principal of such mortgage is payable in installments, adjustments to the basis of the premium must be made for all taxable years (whether or not the institution was exempt from tax during such years) in which installment payments are received. Such adjustments may be made on an individual mortgage basis or on a composite basis by reference to the average period of payments of the mortgage loans of such institution. For the purpose of this adjustment, the term "premium" includes the excess of the acquisition value of the mortgage over its maturity value. The acquisition value of the mortgage is the cost including buying commissions, attorneys' fees, or brokerage fees, but such value does not include amounts paid for accrued interest.

§ 39.113 (b) (2) *Statutory provisions; adjusted basis for determining gain or loss; substituted basis.*

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 (2), adjusted as hereinafter provided. * * *

(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.

§ 39.113 (b) (2)-1 *Substituted basis.* (a) 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 § 39.113 (b) (1)-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 adjustments indicated in §§ 39.113 (b) (1)-2, 39.113 (b) (3)-1, and 39.113 (b) (3)-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.

(b) The application of this section may be illustrated by the following example:

Example. A, who makes his returns upon the calendar year basis, in 1935 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 1952, 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.

§ 39.113 (b) (3) *Statutory provisions; adjusted basis for determining gain or loss; discharge of indebtedness.*

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 (2), adjusted as hereinafter provided. * * *

(3) *Discharge of indebtedness.* Where in the case of a corporation any amount is excluded from gross income under section 22 (b) (9) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. The amount to be so applied (not in excess of the amount so excluded from gross income, reduced by the amount of any deduction disallowed under section 22 (b) (9)) and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Commissioner with the approval of the Secretary) in effect at the time of the filing of the consent by the taxpayer referred to in section 22 (b) (9). The reduction shall be made as of the first day of the taxable year in which the discharge occurred except in the case of property not held by the taxpayer on such first day, in which case it shall take effect as of the time the holding of the taxpayer began.

[Sec. 113 (b) (3) as added by sec. 215 (b), Rev. Act 1939]

§ 39.113 (b) (3)-1 *Adjusted basis; discharge of corporate indebtedness; general rule.* (a) In addition to the adjustments provided in section 113 (b) (1) and § 39.113 (b) (1)-1 which are required to be made with respect to the cost or other basis of property, and except as otherwise provided in section 113 (a) (21) or (22), or 113 (b) (4), a further adjustment shall be made in any case in which there shall have been an exclusion from gross income under section 22 (b) (9) on account of the discharge of indebtedness of a corporation during the taxable year. Such further adjustments shall, except as otherwise provided in § 39.113 (b) (3)-2, 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 discharged, 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 section) by an amount equal to the amount excluded from gross income under section 22 (b) (9) and attributable to the discharge of the indebtedness so incurred with respect to such property:

(2) In the case of specific property (other than inventory or notes or accounts receivable) against which, at the time of the discharge 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 section) by an amount equal to the amount excluded from gross income under section 22 (b) (9) and attributable to the discharge of the indebtedness secured by such lien;

(3) Any excess of the total amount excluded from gross income under section 22 (b) (9) over the sum of the adjustments made under subparagraphs (1) and (2) of this paragraph 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 such subparagraphs) 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 section) in an amount equal to such proportion of such excess as the adjusted basis (without reference to this section) of each such unit of property bears to the sum of adjusted bases (without reference to this section) of all the property of the debtor other than inventory and notes and accounts receivable; and

(4) Any excess of the total amount excluded from gross income under section 22 (b) (9) over the sum of the adjustments made under subparagraphs (1) (2) and (3) of this paragraph 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 section) 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.

(b) For the purposes of this section:

(1) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(2) 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:

(3) The phrase "amount excluded from gross income under section 22 (b) (9)" means the amount of income excluded under that section reduced by any deduction disallowed under that section for unamortized discount;

(4) Adjustments to basis shall be made:

(i) In the case of property owned on the first day of the taxable year, as of that day:

(ii) In the case of property acquired after the first day of the taxable year, as of the day so acquired—

regardless of the time such property was subsequently sold, exchanged, or otherwise disposed of by the taxpayer;

(5) Whenever a discharge of indebtedness is accomplished by a transfer of the taxpayer's property in kind, the difference between the amount of the obligation discharged and the fair market value of the property transferred is the amount which may be applied in reduction of basis;

(6) Regardless of the amount excluded by the taxpayer from its gross income under section 22 (b) (9) and so stated on Form 982, the maximum amount by which basis may be reduced in respect of the discharge of any indebtedness is the amount of income resulting from the discharge of such indebtedness.

(7) Effective with respect to a discharge of indebtedness occurring within a taxable year ending after December 31, 1950, except in the case of a consent filed before April 7, 1953, any reduction in basis which remains to be taken (by reason of an exclusion from gross income under section 22 (b) (9)) after the application of subparagraph (1) of paragraph (a) of this section shall be applied first against property of a character subject to the allowance for depreciation under section 23 (l) property with respect to which a deduction for amortization is allowable under section 23 (t), and property with respect to which a deduction for depletion is allowable under section 23 (m) (but not including property specified in section 114 (b) (2), (3), or (4) in the order in which such property is described in subparagraphs (2) and (3) of paragraph (a) of this section. Any further adjustment in basis required to be made under section 22 (b) (9) shall be applied against other property in the order prescribed in subparagraphs (2), (3) and (4) of paragraph (a) of this section.

(c) The application of paragraph (a) of this section may be illustrated by the following examples:

Example (1). On January 1, 1952, the N Corporation owned an office building, which it sold in March 1952. In June 1952 it purchased a factory building. In October 1952 the N Corporation bought in its outstanding bonds at less than their face value. Assuming that there is a proper exclusion from gross income under section 22 (b) (9), the basis of each building shall be adjusted under section 113 (b) (3) for the taxable year 1952. (But see § 39.113 (b) (3)–2.)

Example (2). The M Corporation has outstanding an issue of A bonds which it had sold at a premium and an issue of B bonds which it had sold at a discount. In July 1952 the M Corporation purchased such outstanding bonds for less than face value. The amount of income attributable to the discharge of the A bonds is $1,000 and the amount of unamortized premium is $200. The amount of income attributable to the discharge of the B bonds is $1,000 and the amount of unamortized discount is $50. If the M Corporation under section 22 (b) (9) elects to have excluded from gross income the amount of income attributable to the discharge of both bond issues, the total reduction in basis of the property of the M Corporation shall not exceed $2,150. If the M Corporation elects only with respect to the A bonds, the total reduction in basis shall not exceed $1,200 (or $950 if the election is with respect to the B bonds). If the M Corporation excludes only an amount of $500 with respect to the A bonds, the total reduction in basis may nevertheless be $1,200 (or $950 if the exclusion is with respect to the B bonds).

§ 39.113 (b) (3)–2 *Adjusted basis; discharge of corporate indebtedness; special cases.* (a) Section 39.113 (b) (3)–1 prescribes the general rule to be followed in adjusting basis of property where there is a proper exclusion from gross income under section 22 (b) (9) The taxpayer may, however, have the basis of its property adjusted in a manner different from that set forth in § 39.113 (b) (3)–1 upon a proper showing to the satisfaction of the Commissioner. Such adjustment, however, shall be consistent with the principles of § 39.113 (b) (3)–1 (b) (7). Variations from such general rule may, for example, involve adjusting the basis of only part of the taxpayer's property or adjusting the basis of all the taxpayer's property, according to a fixed allocation.

(b) A request for variations from the general rule prescribed in § 39.113 (b) (3)–1 shall be filed by the taxpayer with its return for the taxable year in which the discharge of indebtedness occurred unless a consent is permitted (under § 39.22 (b) (9)–1) after the original return has been filed, in which case such request shall be filed with the amended return or claim for credit or refund, as the case may be. Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effected only by a closing agreement entered into under the provisions of section 3760. If no agreement is reached between the taxpayer and the Commissioner as to variations from the general rule prescribed in § 39.113 (b) (3)–1, then the consent filed on Form 982 shall be deemed to be a consent to the application of such general rule and such general rule shall prevail in the determination of the basis of the taxpayer's property, unless the taxpayer specifically states on such form that it does not consent to the application of the general rule.

§ 39.113 (b) (4) *Statutory provisions; adjusted basis for determining gain or*

loss; adjustment of capital structure before September 22, 1938.

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 (2), adjusted as hereinafter provided. * * *

(4) *Adjustment of capital structure prior to September 22, 1938.* Where a plan of reorganization of a corporation, approved by the court in a proceeding under section 77B of the National Bankruptcy Act, as amended, is consummated by adjustment of the capital or debt structure of such corporation without the transfer of its assets to another corporation, and a final judgment or decree in such proceeding has been entered prior to September 22, 1938, then the provisions of section 270 of the National Bankruptcy Act, as amended, shall not apply in respect of the property of such corporation. For the purposes of this paragraph the term "reorganization" shall not be limited by the definition of such term in section 112 (g).

[Sec. 113 (b) (4) as added by sec. 122, Rev. Act 1943]

§ 39.113 (b) (4)-1 *Adjusted basis; exception to section 270 of the Bankruptcy Act, as amended.* The adjustment to basis provided by section 270 of the Bankruptcy Act (11 U. S. C. 670) and by §§ 39.113 (b) (1)-2 and 39.113 (b) (1)-3 shall not be made if, in a proceeding under section 77B of such act, 48 Stat. 912, indebtedness was canceled in pursuance of a plan of reorganization which was consummated by adjustment of the capital or debt structure of the insolvent corporation, and the final judgment or decree in such proceeding was entered before September 22, 1938. Section 113 (b) (4) and this section do not apply if the plan of reorganization under section 77B was consummated by the transfer of assets of the insolvent corporation to another corporation.

§ 39.113 (c) *Statutory provisions; adjusted basis for determining gain or loss; property on which lessee has made improvements.*

SEC. 113. *Adjusted basis for determining gain or loss.* * * *

(c) *Property on which lessee has made improvements.* Neither the basis nor the adjusted basis of any portion of real property shall, in the case of the lessor of such property, be increased or diminished on account of income derived by the lessor in respect of such property and excludable from gross income under section 22 (b) (11). If an amount representing any part of the value of real property attributable to buildings erected or other improvements made by a lessee in respect of such property was included in gross income of the lessor for any taxable year beginning before January 1, 1942, the basis of each portion of such property shall be properly adjusted for the amount so included in gross income.

[Sec. 113 (c) as added by sec. 115 (b), Rev. Act 1942]

§ 39.113 (c)-1 *Property on which lessee has made improvements.* In any case in which a lessee of real property has erected buildings or made other improvements upon the leased property and the lease is terminated by forfeiture or otherwise resulting in the realization by such lessor of income which, were it not for the provisions of section 22 (b) (11) would be includible in gross income of the lessor, the amount so excluded from gross income shall not be taken into account in determining the basis or the adjusted basis of such property or any portion thereof in the hands of the lessor. If, however, in any taxable year beginning before January 1, 1942, there has been included in the gross income of the lessor an amount representing any part of the value of such property attributable to such buildings or improvements, the basis of each portion of such property shall be properly adjusted for the amount so included in gross income. For example, A leased in 1930 to B for a period of 25 years unimproved real property and in accordance with the terms of the lease B erected a building on the property. It was estimated that upon expiration of the lease the building would have a depreciated value of $50,000, which value the lessor elected to report (beginning in 1931) as income over the term of the lease. This method of reporting was used until 1942. In 1952 B forfeits the lease. The amount of $22,000 reported as income by A during the years 1931 to 1941, inclusive, shall be added to the basis of the property represented by the improvements in the hands of A. If in such case A did not report during the period of the lease any income attributable to the value of the building erected by the lessee and the lease was forfeited in 1940 when the building was worth $75,000, such amount, having been included in gross income under the law applicable to that year, is added to the basis of the property represented by the improvements in the hands of A. As to treatment of such property for the purposes of capital gains and losses, see section 117.

§ 39.113 (d) *Statutory provisions; adjusted basis for determining gain or loss; depreciation, etc., allowed before 1952.*

SEC. 113. *Adjusted basis for determining gain or loss.* * * *

(d) *Election in respect of depreciation, etc., allowed before 1952.* Any person may elect to have clause (ii) of subsection (b) (1) (B) apply in respect of periods since February 28, 1913, and before January 1, 1952. Such an election shall be made in such manner as the Secretary may be regulations prescribe, shall be irrevocable, and shall apply in respect of all property held by the person making the election at any time on or before the date on which the election was made and in respect of all periods since February 28, 1913, and before January 1, 1952, during which such person held such property or for which adjustments must be made under subsection (b) (2). An election by a transferor, donor, or grantor made after the date of the transfer, gift, or grant of property shall not affect the basis of such property in the hands of the transferee, donee, or grantee. No such election may be made after December 31, 1952.

[Sec. 113 (d) as added by sec. 2, Pub. Law 539 (82d Cong.)]

§ 39.113 (d)-1 *Election as to amounts allowed in respect of depreciation, etc., before 1952*—(a) *In general.* (1) Any person may elect to have the adjustments to the cost or other basis of property under section 113 (b) (1) (B) determined in accordance with clause (ii) of such section, by filing with the district director of internal revenue, on or before December 31, 1952, the written statement of election provided in paragraph (b) of this section. The statement must be filed with the district director with whom the return must be filed (determined under section 53 (b) as of December 31, 1952). Such election shall be irrevocable after December 31, 1952, and shall apply with respect to all periods since February 28, 1913, and before January 1, 1952. The election shall apply to all properties held by the person making the election at any time on or before the date of such election.

(2) A taxpayer may include in an election filed before December 31, 1952, a statement that the election shall take effect when filed, and in such case the election shall be irrevocable on the date filed, and shall not apply to any property acquired by the taxpayer after such date. If an election is made before December 31, 1952, and does not contain such statement, the election may be revoked by filing on or before December 31, 1952, in the same office in which the election was filed, a statement of revocation executed in the same manner as the election. Such an election made before December 31, 1952, and not revoked on or before that date, shall be deemed made on December 31, 1952, and shall apply to all property held by the taxpayer at any time on or before such date.

(3) A copy of the written statement of election must be filed with the first income tax return, amended return, or claim for refund filed on or after the date on which the election is made.

(4) An election by a partner is not an election by the partnership of which he is a member, but a separate election must be made by the partnership. Similarly, an election by the partnership applies only with respect to the partnership, and is not applicable to the separate property of the partners. A similar rule applies with respect to elections by trusts and beneficiaries of such trusts.

(5) An election which conforms in substance to the provisions of this section shall not be deemed invalid solely because it was filed prior to the date on which the regulations in this section were promulgated.

(b) *Rules applicable to making of election.* The following rules are applicable to the making of an election under section 113 (d)

(1) *Form of election.* The election shall be in the form of a statement in writing addressed to the district director of internal revenue with whom filed, shall state the name and address of the taxpayer making the election, and shall contain a statement that such taxpayer elects to have the provisions of section 113 (b) (1) (B) (ii) apply in respect of all periods since February 28, 1913, and before January 1, 1952.

(2) *Signature.* The statement shall be signed by the taxpayer making the election, if an individual, or, if the taxpayer making the election is not an individual, the statement shall be executed in the same manner as is required in the

case of the income tax return of such taxpayer.

(3) *Filing.* The written statement must be filed in the office of the district director of internal revenue on or before December 31, 1952. An election shall be considered as timely filed if it is placed in the mail on or before midnight of December 31, 1952, as shown by the postmark on the envelope containing the written statement of election or as shown by other available evidence of the mailing date.

§ 39.114 *Statutory provisions; basis for 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 the case of mines.* In the case of mines (except mines in respect of which percentage depletion is allowable under paragraph (4) of this subsection) 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 for certain other mines and natural mineral deposits.*—(A) *In general.* The allowance for depletion under section 23 (m) in the case of the following mines and other natural deposits shall be—

(i) In the case of sand, gravel, slate, stone (including pumice and scoria), brick and tile clay, shale, oyster shell, clam shell, granite, marble, sodium chloride, and, if from brine wells, calcium chloride, magnesium chloride, and bromine, 5 per centum,

(ii) In the case of coal, asbestos, brucite, dolomite, magnesite, perlite, wollastonite, calcium carbonates, and magnesium carbonates, 10 per centum,

(iii) In the case of metal mines, aplite, bauxite, fluorspar, flake graphite, vermiculite, beryl, garnet, feldspar, mica, talc (including pyrophyllite), lepidolite, spodumene, barite, ball clay, sagger clay, china clay, phosphate rock, rock asphalt, trona, bentonite, gilsonite, thenardite, borax, fuller's earth, tripoli, refractory and fire clay, quartzite, diatomaceous earth, metallurgical grade limestone, chemical grade limestone, and potash, 15 per centum, and

(iv) In the case of sulfur, 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, 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.

(B) *Definition of gross income from property.* As used in this paragraph the term "gross income from the property" means the gross income from mining. The term "mining" as used herein, shall be considered to include not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills. The term "ordinary treatment processes" as used herein, shall include the following: (i) In the case of coal—cleaning, breaking, sizing, and loading for shipment; (ii) in the case of sulphur—pumping to vats, cooling, breaking, and loading for shipment; (iii) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment; and (iv) in the case of lead, zinc, copper, gold, silver, or fluorspar ores, potash, and ores which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including as an ordinary treatment process electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore, including the furnacing of quicksilver ores. The principles of this subparagraph shall also be applicable in determining gross income attributable to mining for the purposes of sections 450 and 453.

[Sec. 114 as amended by sec. 145, Rev. Act 1942; sec. 124 (a) (b) (c), Rev. Act 1943; sec. 15 (a) (b) (c), Pub. Law 384 (80th Cong.); sec. 207 (a), Rev. Act 1950; sec. 304 (d), Excess Profits Tax Act 1950; sec. 319 (a) (b), Rev. Act 1951]

§ 39.114-1 *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 that as provided in § 39.23 (m)-21 in the case of the cutting of timber which is considered to be a sale or exchange of such timber under section 117 (k) (1), the basis shall be the fair market value of such timber as of the first day of the taxable year in which it is cut; and except as provided in § 39.23 (m)-3, relating to depletion based on discovery value, in § 39.23 (m)-4, relating to percentage depletion in the case of oil and gas wells, in § 39.23 (m)-5, relating to percentage depletion in the case of certain minerals, and in sections 23 (cc) (3) and 23 (ff) (4), relating to basis for depletion.

§ 39.115 (a) *Statutory provisions; distributions by corporations; definition of dividend.*

SEC. 115. *Distributions by corporations*—(a) *Definition of dividend.* The term "dividend" when used in this chapter (except in section 201 (c) (5), section 204 (c) (11) and section 207 (a) (2) and (b) (3) (where the reference is to dividends of insurance companies paid to policyholders)) 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. In the case of a corporation which, under the law applicable to the taxable year in which the distribution is made, is a personal holding company, or which, for the taxable year in respect of which the distribution is made under section 504 (c) or section 506 or a corresponding provision of a prior income-tax law, is a personal holding company under the law applicable to such taxable year, such term also means any distribution (whether or not a dividend as defined in the preceding sentence) to its shareholders, whether in money or in other property, to the extent of its subchapter A net income, less the sum of the following:

(1) The net operating loss credit provided in section 26 (c) (1);

(2) The dividend carry-over provided in section 27 (c); and

(3) The deduction for amounts for retirement of indebtedness provided in section 504 (b).

[Sec. 115 (a) as amended by secs. 166, 186 (a) (1), Rev. Act 1942; sec. 512 (a), Rev. Act 1943; sec. 1, Pub. Law 113 (80th Cong.)]

§ 39.115 (a)-1 *Dividends.* (a) The term "dividend" for the purpose of chapter 1 (except when used in section 201 (c) (5) section 204 (c) (11) and section 207 (a) (2) and (b) (3) where the reference is to dividends of insurance companies paid to policyholders) 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.

(b) In the case of a corporation which, under the law applicable to the taxable year in which a distribution is made, is a personal holding company or which, for the taxable year in respect of which a distribution is made under section 504 (c) relating to dividends paid within 2½ months after the close of the taxable year, or section 506, relating to deficiency dividends, or corresponding provisions of a prior income-tax law, was under the applicable law a personal holding company, the term "dividend," in addition to the meaning set forth in the first sentence of section 115 (a) also means a distribution to its shareholders as follows: A distribution within a taxable year of the corporation, or of a shareholder, is a dividend to the extent of the corporation's subchapter A net income less the sum of the net operating loss credit provided in section 26 (c) (1) the dividend carry-over provided in section 27 (c) and the deduction for amounts for retirement of indebtedness provided in section 504 (b) for the taxable year in which, or, in the case of a distribution under section 504 (c) or section 506, the taxable year in respect of which, the distribution is made.

(c) The term "dividend" does not include distributions under section 115 (c) relating to distributions in liquidation, section 115 (e) relating to distributions by personal service corporations, or section 115 (f) relating to stock dividends, or certain distributions by insurance companies. In all other cases the term includes any distribution to shareholders to the extent made out of accumulated or current earnings or profits.

(d) 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.

(e) The application of section 115 (a) may be illustrated by the following examples:

Example (1). At the beginning of the calendar year 1952, 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, 1952, the corporation made quarterly distributions of $25,000 during the taxable year to its shareholders. 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).

Example (2). At the beginning of the calendar year 1952, the N Corporation, a personal holding company, had no accumulated earnings or profits. During that year it made no earnings or profits but its subchapter A net income, due to the disallowance of certain deductions, was $16,000. It distributed to shareholders on December 15, 1952, $15,000, and on February 1, 1953, $1,000, the latter amount being claimed as a deduction under section 504 (c) in its personal holding company return for 1952 filed on March 15, 1953. Both distributions are taxable dividends in full, since they do not exceed the subchapter A net income for 1952, the taxable year in which the distribution of $15,000 was made and with respect to which the distribution of $1,000 was made. It is immaterial whether the N Corporation is a personal holding company for the taxable year 1953 or whether it had any income for that year.

Example (3). In 1952, a deficiency in personal holding company tax was established against the O Corporation for the taxable year 1948 in the amount of $35,500 based on an undistributed subchapter A net income of $42,000 which consisted of a subchapter A net income of $52,000 minus a deduction of $10,000 for amounts used for retirement of indebtedness provided in section 504 (b). The O Corporation complied with the provisions of section 506 and in December 1952 distributed $42,000 to its stockholders as "deficiency dividends." The distribution of $42,000 is a taxable dividend since it does not exceed $42,000 (subchapter A net income of $52,000 for 1948, the taxable year with respect to which the distribution was made, minus the deduction for retirement of indebtedness of $10,000). It is immaterial whether the O Corporation is a personal holding company for the taxable year 1952 or whether it had any income for that year.

Example (4). At the beginning of the taxable year 1952, the P Corporation, a personal holding company, had a deficit in earnings and profits of $200,000. During that year it made earnings and profits of $55,000. For that year, however, it had a subchapter A net income of $100,000, a net operating loss credit under section 26 (c) (1) of $10,000 and a deduction for retirement of indebtedness under section 504 (b) of $10,000. During such taxable year it distributed to its shareholders $100,000. The distribution of $100,000 is a taxable dividend to the extent of $80,000 (subchapter A net income of $100,000 minus the net operating loss credit of $10,000 and the deduction for retirement of indebtedness of $10,000). No interest shall be allowed or paid in respect of any overpayment of tax resulting from the inclusion in taxable income by any shareholder of his proportionate share of the distribution of $100,000.

Example (5). If the facts were the same as in example (4) except that the P Corporation had earnings and profits for the taxable year 1952 of $90,000, the distribution of $100,000 would be a taxable dividend to the extent of $90,000 since its earnings and profits for that year, $90,000, exceed $80,000 (subchapter A net income of $100,000 minus the net operating loss credit of $10,000 and the deduction for retirement of indebtedness of $10,000).

§ 39.115 (a)-2 *Earnings or profits.* (a) In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated before March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204 (b) (5) and which is segregated accordingly in the unearned premium reserve.

(b) 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) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see § 39.115 (e)-1) 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.

(c) (1) In the case of a corporation in which depletion or depreciation is a factor in the determination of income, the only depletion or depreciation deductions to be considered in the computation of the total earnings and profits are those based on cost or other basis without regard to March 1, 1913, value. In computing the earnings and profits for any period beginning after February 28, 1913, the only depletion or depreciation deductions to be considered are those based on (i) costs or other basis, if the depletable or depreciable asset was acquired subsequent to February 28, 1913, or (ii) adjusted cost or March 1, 1913, value, whichever is higher, if acquired before March 1, 1913. Thus, discovery or percentage depletion under all Revenue Acts for mines and oil and gas wells is not to be taken into consideration in computing the earnings and profits of a corporation. Similarly, where the basis of property in the hands of a corporation is a substituted basis, such basis, and not the fair market value of the property at the time of the acquisition by the corporation, is the basis for computing depletion and depreciation for the purpose of determining earnings and profits of the corporation.

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

Example. Oil producing property which A had acquired in 1946 at a cost of $28,000 was transferred to the Y Corporation in December 1948, in exchange for all of its capital stock. The fair market value of the stock and of the property as of the date of the transfer was $247,000. The Y Corporation, after four years' operations, effected in 1952 a cash distribution to A in the amount of $165,000. In determining the extent to which the earnings and profits of the Y Corporation available for dividend distributions have been increased as the result of production and sale of oil, the depletion to be taken into account is to be computed upon the basis of $28,000 established in the nontaxable exchange in 1948 regardless of the fair market value of the property or of the stock issued in exchange therefor.

(d) A loss sustained for a year before 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 before 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.

(e) 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 before August 6, 1917, out of earnings or profits accumulated before March 1, 1913, which distributions were specifically declared to be out of earnings or profits accumulated before March 1, 1913, see section 31 (b) of the Revenue Act of 1916, as amended by section 1211 of the Revenue Act of 1917.

§ 39.115 (a)-3 *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.* (a) 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.

(b) If a transaction described in paragraph (a) of this section has occurred, there shall be included in the accumulated earnings and profits of the transferee corporation as of the day on which such transaction occurred the proportionate part of any earnings and profits of the transferor corporation accumulated as of such day and properly allocable to the transferee; and there shall be included in the current earnings and profits of the transferee for the taxable year of the transferee in which such transaction occurred the proportionate part of the earnings and profits of the transferor accumulated after the beginning of such taxable year and properly allocable to the transferee. The amount so included in the current earnings and profits of the transferee shall not exceed such proportionate part of the earnings and profits of the transferor accumulated as of the day on which such transaction occurred.

(c) 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—

(i) Of stock or securities in such corporation or in another corporation a party to the reorganization 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

(ii) Of stock (other than preferred stock) in another corporation which is a party to the reorganization without the surrender by the distributees of stock in the distributing corporation if the distribution occurs after October 20, 1951 (see section 112 (b) (11)) or

(iii) Of stock or securities in such corporation or in another corporation a party to the reorganization in any taxable year (beginning before January 1, 1939, 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, 1939, 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 of the Revenue Act of 1938, or of the Internal Revenue Code.

(3) The distribution in any taxable year (beginning after December 31, 1938) 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.

(5) The distribution, in a taxable year of the distributee beginning after December 31, 1931, by or on behalf of an insolvent corporation, in connection with a section 112 (b) (10) reorganization, of stock or securities in a corporation organized or made use of to effectuate the plan of reorganization, if under section 112 (l) no gain to the distributee from the receipt of such stock or securities was recognized by law.

A distribution described in subparagraph (1) (2) (3), (4), or (5) of this paragraph 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 subparagraph (1) (2) (3) or (5) of this paragraph) 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.

(d) For the purposes of this section, 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; 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; and for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938.

§ 39.115 (b) *Statutory provisions; distributions by corporations; source of distribution.*

SEC. 115. *Distributions by corporations.* * * *

(b) *Source of distributions.* For the purposes of this chapter 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. The preceding sentence shall not apply to a distribution which is a dividend within the meaning of the last sentence of subsection (a).

[Sec. 115 (b) as amended by sec. 186 (b), Rev. Act 1942]

§ 39.115 (b)-1 *Sources of distribution in general.* (a) 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 before 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.

(b) 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 § 39.115 (a)-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, 1936, 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.

(c) The provisions of this section may be illustrated by the following example:

Example. At the beginning of the calendar year 1952, the M Corporation had $12,000 in earnings and profits accumulated since February 28, 1913. Its earnings and profits for 1952 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 before the taxable year, as follows:

Distributions during 1952		Portion out of earnings or profits of the taxable year	Portion out of earnings accumulated since Feb. 28, 1913, and before the taxable year	Taxable amount of each distribution
Date	Amount			
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

(d) Any distribution by a corporation out of earnings or profits accumulated before March 1, 1913, or out of increase in value of property accrued before March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether before, on, or after March 1, 1913) is not a dividend within the meaning of chapter 1.

§ 39.115 (c) *Statutory provisions; distributions by corporations; distributions in liquidation.*

SEC. 115. *Distributions by corporations.* * * *

(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. In the case of amounts distributed (whether before January 1, 1939, 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 partial liquidation or 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 gain from the sale or exchange of a capital asset held for not more than 6 months.

[Sec. 115 (c) as amended by sec. 147, Rev. Act 1942]

§ 39.115 (c)-1 *Distributions in liquidation.* (a) 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 § 39.111-1, 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, and shall be subject to the provisions of section 117.

(b) 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.

(c) 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 §§ 39.27 (g)-1 and 39.115 (a)-3.

(d) For the purposes of the last sentence of section 115 (c), a liquidation may be completed before 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)

(e) For the purposes of this section 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 and the regulations thereunder.

(f) The provisions of this section may be illustrated by the following examples:

Example (1). A, an individual who makes his income tax returns on the calendar year basis, owns 20 shares of stock of the P Corporation, a domestic corporation, 10 shares of which were acquired in 1941 at a cost of $1,500, and the remainder of 10 shares in December 1951 at a cost of $2,900. He receives in April 1952 a distribution of $250 per share in complete liquidation, or $2,500 on the 10 shares acquired in 1941, and $2,500 on the 10 shares acquired in December 1951. The gain of $1,000 on the shares acquired in 1941 is a long-term capital gain to be treated as provided in section 117. The loss of $400 on the shares acquired in 1951 is a short-term capital loss to be treated as provided in section 117.

Example (2). A, an individual who makes his income tax returns on the calendar year basis, owned 20 shares of participating preferred stock of the Z Corporation, 10 shares of which were acquired in 1943 for $1,700 and 10 shares of which were acquired in January

1952 for $1,120. In May 1952 the corporation in a transaction qualifying as a partial liquidation redeemed the entire issue of preferred stock by paying the holders thereof $152 per share. A received $1,520 on the 10 shares acquired in 1943, and $1,520 on the 10 shares acquired in January 1952. The loss of $180 on the shares acquired in 1943 is a long-term capital loss to be treated as provided in section 117. The gain of $400 on the shares acquired in January 1952 is a short-term capital gain to be treated as provided in section 117.

§ 39.115 (d) *Statutory provisions; distributions by corporations; other distributions from capital.*

SEC. 115. *Distributions by corporations.*
* * *

(d) *Other distributions from capital.* If any distribution 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. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f) (1), is not treated as a dividend, whether or not otherwise a dividend.

[Sec. 115 (d) as amended by sec. 214 (b), Rev. Act 1939]

§ 39.115 (d)-1 *Distributions other than a dividend.* (a) 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 §§ 39.115 (a)-1 and 39.115 (b)-1)

(2) A distribution out of increase in value of property accrued before March 1, 1913,

(3) A distribution in partial or complete liquidation (see § 39.115 (c)-1) or

(4) A distribution which, under section 115 (f) (1) is not treated as a dividend (see § 39.115 (f)-1,

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 paragraph are applicable to such distributions received by one corporation from another corporation. A distribution out of increase in value of property accrued before March 1, 1913, shall be applied against and reduce the adjusted basis of the stock provided in section 113 (b) but the fact that such distribution is in excess of such basis does not render such excess subject to tax.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. In 1952 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 before 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.

§ 39.115 (d)-2 *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 § 39.111-1. 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 §§ 39.111-1 and 39.115 (d)-1. No distribution, however, can be made from such a reserve until all the earnings or profits of the corporation have first been distributed.

§ 39.115 (e)—(f) *Statutory provisions; distributions by corporations; distributions by personal service corporations; stock dividends.*

SEC. 115. *Distributions by corporations.*
* * *

(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, 40 Stat. 1070, or section 218 of the Revenue Act of 1921, 42 Stat. 245, 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.

§ 39.115 (f)-1 *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. A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock which would not otherwise be treated as a dividend shall not be so treated merely because such distribution was made out of treasury stock or consisted of rights to acquire treasury stock.

§ 39.115 (f)-2 *Election of shareholders as to medium of payment.* (a) If the shareholder has the right to an election or option with respect to whether a distribution shall be paid either in money or any other property or 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.

(b) As used in this section, the term "any other property" 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 § 39.115 (f)-1.

§ 39.115 (g) *Statutory provisions; distributions by corporations; redemption of stock.*

SEC. 115. *Distributions by corporations.* * * *

(g) *Redemption of stock*—(1) *In general.* 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.

(2) *Redemption through use of subsidiary corporation.* If stock of a corporation (hereinafter referred to as the issuing corporation) is acquired by another corporation (hereinafter referred to as the acquiring corporation) and the issuing corporation controls (directly or indirectly) the acquiring corporation, the amount paid for the acquisition of the stock shall constitute a taxable dividend from the issuing corporation to the extent that the amount paid for such stock would have been considered, under paragraph (1), as essentially equivalent to a taxable dividend if such amount had been distributed by the acquiring corporation to the issuing corporation and had been applied by the issuing corporation in redemption of its stock. For the purposes of this paragraph, control means the ownership of stock possessing at least 50 per centum of the total combined voting power of all classes of stock entitled to vote or at least 50 per centum of the total value of shares of all classes of stock of the corporation.

(3) *Redemption of stock to pay death taxes.* The provisions of this subsection shall not apply to such part of any amount so distributed with respect to stock the value of which is included in determining the value of the gross estate of a decedent in accordance with section 811, as is distributed after such decedent's death and within the period of limitations for the assessment of estate tax provided in section 874 (a) (determined without the application of section 875) or within 90 days after the expiration of such period, and as is not in excess of the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent's death: *Provided,* That the value of the stock in such corporation for estate tax purposes comprises more than 35 per centum of the value of the gross estate of such decedent.

[Sec. 115 (g) as amended by secs. 208 (a), 209 (a), Rev. Act 1950; sec. 320 (a), Rev. Act 1951]

§ 39.115 (g)-1 *Distribution in redemption or cancellation of stock taxable as a dividend*—(a) *In general.* (1) 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.

(2) 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.

(b) *Redemption of stock through use of subsidiary corporation.* (1) If stock of one corporation (hereinafter referred to as the "issuing corporation") is acquired from a shareholder of such corporation by another corporation (hereinafter referred to as the "acquiring corporation") and if the issuing corporation controls, directly or indirectly, the acquiring corporation, the amount paid for such stock may constitute a taxable dividend to such shareholder. For the purpose of this paragraph, the issuing corporation is deemed to control the acquiring corporation if it owns, directly or indirectly, stock possessing 50 percent or more of the total combined voting power of all classes of stock of the acquiring corporation entitled to vote or 50 percent or more of the total value of shares of all classes of stock of such corporation.

(2) Where stock of one corporation is acquired by another corporation and the issuing corporation controls the acquiring corporation, the amount paid for the stock shall be treated, under section 115 (g) as though such amount had first been distributed to the issuing corporation and immediately thereafter had been distributed by such corporation in redemption of such stock, to the shareholders from whom such stock was acquired. If and to the extent a distribution by the issuing corporation under such circumstances would be treated as essentially equivalent to the distribution of a taxable dividend under the principles of paragraph (a) of this section, the amount paid by the acquiring corporation shall be considered a dividend to the shareholder from the issuing corporation.

(c) *Redemption of stock to pay death taxes.* (1) Section 115 (g) (3) of the Internal Revenue Code provides that in certain cases a distribution in cancellation or redemption of stock, the value of which is included in determining the value of the gross estate of a decedent, shall not be treated as a dividend under section 115 (g) Section 115 (g) (3) applies only where the distribution is with respect to stock of a corporation the value of whose stock in the gross estate of the decedent for purposes of the Federal estate tax is an amount in excess of 35 percent of the gross estate of such decedent.

(2) For the purpose of section 115 (g) (3) the term "gross estate" means the gross estate as computed in accordance with section 811 of the Code. See §§ 81.10 to 81.28, inclusive, and § 81.38 of this chapter (Regulations 105)

(3) In determining whether the estate of the decedent is comprised of stock of a corporation of sufficient value to satisfy the percentage requirements of section 115 (g) (3) the total value, in aggregate, of all classes of stock of a corporation includible in the gross estate is taken into account. Thus, if the gross estate of the decedent, valued for purposes of the Federal estate tax at $1,000,000, includes common stock of Corporation A valued at $250,000, preferred stock of Corporation A valued at $110,000, preferred stock of Corporation B valued at $370,000, and common stock of Corporation C valued at $50,000, section 115 (g) (3) is applicable to distributions in cancellation or redemption of either common or preferred stock of Corporation A (comprising $360,000/$1,000,000 or 36 percent of the gross estate) or preferred stock of Corporation B (comprising $370,000/$1,000,000 or 37 percent of the gross estate) but not to distributions in cancellation or redemption of stock of Corporation C (comprising only 5 percent of the gross estate)

(4) Section 115 (g) (3) applies to distributions made after the death of the decedent and before the expiration of the 3-year period of limitations for the assessment of estate tax provided in section 874 (a) (determined without the application of any provision of law extending or suspending the running of such period of limitations) or within 90 days after the expiration of such period. Since the period for assessment of estate tax prescribed in section 874 (a) is a period of three years after the filing of the estate tax return, section 115 (g) (3) applies only to distributions made not later than three years and 90 days after the filing of the estate tax return.

(5) While section 115 (g) (3) will most frequently have application in the case where stock is canceled or redeemed from the executor or administrator of an estate, the section is also applicable to distributions in cancellation or redemption of stock included in the decedent's gross estate and held at the time of the redemption by any person who acquired the stock by any of the means comprehended by the subdivisions of section 811, including the heir, legatee, or donee of the decedent, a surviving joint tenant, surviving spouse, appointee, or taker in default of appointment, or a trustee of a trust cre-

ated by the decedent. Thus, section 115 (g) (3) may apply with respect to a distribution in cancellation or redemption of stock from a donee to whom the decedent has transferred stock in contemplation of death where the value of such stock is included in the decedent's gross estate under section 811 (c) (1) (A) Similarly, section 115 (g) (3) may apply to the redemption of stock from a beneficiary of the estate to whom an executor has distributed the stock pursuant to the terms of the will of the decedent. However, section 115 (g) (3) is not applicable to the case where stock is redeemed from a stockholder who has acquired the stock by gift or purchase from any person to whom such stock has passed from the decedent.

(6) The total application of section 115 (g) (3) with respect to stock included in the gross estate of any decedent can never exceed the amount of the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of the decedent's death. In determining whether the total distributions in redemption of such stock made within the period of time prescribed in section 115 (g) (3) exceed the amount of such taxes and interest, account shall be taken of all such distributions without regard to whether any distribution would be treated as a dividend were it not for section 115 (g) (3).

(7) For the purpose of section 115 (g) (3) the Federal estate tax or any other estate, inheritance, legacy, or succession tax shall be ascertained after the allowance of any credit, relief, discount, refund, remission, or reduction of tax.

(8) The sole effect of section 115 (g) (3) is to exempt from tax as a dividend a distribution to which such section is applicable when made in redemption of stock includible in a decedent's gross estate. Such section does not, however, in any other manner affect the principles set forth in paragraph (a) of this section. Thus, if stock of a corporation is owned equally by A, B, and the C Estate, and the corporation redeems one-half of the stock of each shareholder, the determination of whether the distributions to A and B are essentially equivalent to dividends shall be made without regard to the effect which section 115 (g) (3) may have upon the taxability of the distribution to the C Estate.

§ 39.115 (h)-(j) *Statutory provisions; distributions by corporations; effect on earnings and profits of distributions of stock; definition of partial liquidation, valuation of dividend.*

SEC. 115. *Distributions by corporations.* * * *

(h) *Effect on earnings and profits of distributions of stock.* The distribution (whether before January 1, 1939, 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, 48 Stat. 712, 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.

§ 39.115 (j)-1 *Dividends paid in property.* 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. See § 39.42-3. Scrip dividends are subject to tax for the year in which the warrants are issued.

§ 39.115 (k)—(l) *Statutory provisions; distributions by corporations; cross reference; effect on earnings and profits of gain or loss and of receipt of tax-free distributions.*

SEC. 115. *Distributions by corporations* * * *

(k) *Consent distributions.* For taxability as dividends of amounts agreed to be included in gross income by shareholders' consents, see section 28.

(l) *Effect on earnings and profits of gain or loss and of receipt of tax-free distributions.* The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) For the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) For the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For the purposes of this subsection, a loss with respect to which a deduction is disallowed under section 118, or a corresponding provision of a prior income-tax law, shall not be deemed to be recognized. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

[Sec. 115 (l) as added by sec. 501 (a), Second Rev. Act 1940; amended by sec. 146 (a), Rev. Act 1942]

§ 39.115 (l)-1 *Effect on earnings and profits of gain or loss realized after February 28, 1913.* (a) In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 115 (l) prescribes certain rules for

(1) The computation of the total earnings and profits of the corporation, of most frequent application in determining invested capital; and

(2) The computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions.

Such rules are applicable whenever under any provision of chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. For example, since the earnings and profits accumulated after February 28, 1913, or the earnings and profits of the taxable year, are earnings and profits for a period beginning after February 28, 1913, the determination of either must be in accordance with the rules herein prescribed for the ascertainment of earnings and profits for any period beginning after February 28, 1913. Under subparagraph (1) of this paragraph, such gain or loss is determined by using the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, but disregarding value as of March 1, 1913. Under subparagraph (2) of this paragraph above, there is used such adjusted basis for determining gain, giving effect to the value as of March 1, 1913, whenever applicable. In both cases the rules are the same as those governing depreciation and depletion in computing earnings and profits (see § 39.115 (a)-2) Under both subparagraphs (1) and (2) of this paragraph above, the adjusted basis is subject to the limitations of the third sentence of section 115 (l) requiring the use of adjustments proper in determining earnings and profits. The proper adjustments may differ under (1) and (2) of the first sentence of section 115 (l) depending upon the basis to which the adjustments are to be made. If the ap-

plication of (2) of the first sentence of section 115 (l) results in a loss and if the application of (1) of such sentence to the same transaction reaches a different result, then the loss under (2) of such first sentence will be subject to the adjustment thereto required by section 115 (m) (2) See § 39.115 (m)-1.

(b) (1) The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this paragraph, the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 118 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of section 24 (b) and 117 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 118 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The "recognized" gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115 (l) as distinguished from the realized gain or loss used in computing net income.

(2) The application of subparagraph of (1) of this paragraph may be illustrated by the following examples:

Example (1). The X Corporation on January 1, 1952, owned stock in the Y Corporation which it had acquired from the Y Corporation in December 1951, in an exchange transaction in which no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was $30,000. The fair market value of the stock in the Y Corporation when received by the X Corporation was $930,000. On April 9, 1952, the X Corporation made a cash distribution of $900,000 and, except for the possible effect of the transaction in 1951, had no earnings or profits accumulated after February 28, 1913, and had no earnings or profits for the taxable year. The amount of $900,000 representing the excess of the fair market value of the stock of the Y Corporation over the adjusted basis of the property exchanged therefor was not recognized gain to the X Corporation under the provisions of section 112. Accordingly, the earnings and profits of the X Corporation are not increased by $900,000, the amount of the gain realized but not recognized in the exchange, and the distribution was not a taxable dividend. The basis in the hands of the Y Corporation of the property acquired by it from the X Corporation is $30,000. If such property is thereafter sold by the Y Corporation, gain or loss will be computed on such basis of $30,000, and earnings and profits will be increased or decreased accordingly.

Example (2). On January 2, 1910, the M Corporation acquired nondepreciable property at a cost of $1,000. On March 1, 1913, the fair market value of such property in the hands of the M Corporation was $2,200. On December 31, 1952, the M Corporation transfers such property to the N Corporation in exchange for $1,900 in cash and all the N Corporation stock, which has a fair market value of $1,100. For the purpose of computing the total earnings and profits of the M Corporation the gain on such transaction is $2,000 (the sum of $1,900 in cash and stock worth $1,100 minus $1,000, the adjusted basis for computing gain, determined without regard to March 1, 1913, value), $1,900 of which is recognized under section 112 (c), since this was the amount of money received, although for the purpose of computing net income the gain is only $800 (the sum of $1,900 in cash and stock worth $1,100, minus $2,200, the adjusted basis for computing gain determined by giving effect to March 1, 1913, value). Such earnings and profits will therefore be increased by $1,900. In computing the earnings and profits of the M Corporation for any period beginning after February 28, 1913, however, the gain arising from the transaction, like the taxable gain, is only $800, all of which is recognized under section 112 (c), the money received being in excess of such amount. Such earnings and profits will therefore be increased by only $800 as a result of the transaction. For increase in that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after, March 1, 1913, see § 39.115 (m)-1.

Example (3). On July 31, 1952, the R Corporation owned oil producing property acquired after February 28, 1913, at a cost of $200,000, but having an adjusted basis (by reason of taking percentage depletion) of $100,000 for determining gain in computing net income. However, the adjusted basis of such property to be used in computing gain or loss for the purpose of earnings and profits is, because of the provisions of the third sentence of section 115 (l), $150,000. On such day the R Corporation transferred such property to the S Corporation in exchange for $25,000 in cash and all of the S Corporation stock, which had a fair market value of $100,000. For the purpose of computing net income the R Corporation has realized a gain of $25,000 as a result of this transaction, all of which is recognized under section 112 (c). For the purpose of computing earnings and profits, however, the R Corporation has realized a loss of $25,000, none of which is recognized owing to the provisions of section 112 (e). The earnings and profits of the R Corporation are therefore neither increased nor decreased as a result of the transaction. The adjusted basis of the S Corporation stock in the hands of the R Corporation for purposes of computing earnings and profits, however, will be $125,000 (though only $100,000 for the purpose of computing net income), computed as follows:

Basis of property transferred	$200,000
Less money received on exchange	25,000
Plus gain or minus loss recognized on exchange	None
Basis of stock	175,000
Less adjustments (same as those used in determining adjusted basis of property transferred)	50,000
Adjusted basis of stock	125,000

If, therefore, the R Corporation should subsequently sell the S Corporation stock for $100,000, a loss of $25,000 will again be realized for the purpose of computing earnings and profits, all of which will be recognized and will be applied to decrease the earnings and profits of the R Corporation.

(c) (1) The third sentence of section 115 (l) provides for cases in which the adjustments, prescribed in section 113, to the basis indicated in (1) or (2), as the case may be, of the first sentence of section 115 (l) differ from the adjustments to such basis proper for the purpose of determining earnings or profits. The adjustments provided by such third sentence reflect the treatment provided by § 39.115 (a)-2 relative to cases where the deductions for depletion and depreciation in computing net income differ from the deductions proper for the purpose of computing earnings and profits.

(2) The effect of the third sentence of section 115 (l) may be illustrated by the following examples:

Example (1). The X Corporation purchased on January 2, 1931, an oil lease at a cost of $10,000. The lease was operated only for the years 1931 and 1932. The deduction for depletion in each of the years 1931 and 1932 amounted to $2,750, of which amount $1,750 represented percentage depletion in excess of depletion based on cost. The lease was sold in 1952 for $15,000. Under section 113 (b) (1) (B), in determining the gain or loss from the sale of the property, the basis must be adjusted for cost depletion of $1,000 in 1931 and percentage depletion of $2,750 in 1932. However, the adjustment of such basis, proper for the determination of earnings and profits, is $1,000 for each year, or $2,000. Hence, the cost is to be adjusted only to the extent of $2,000, leaving an adjusted basis of $8,000 and the earnings and profits will be increased by $7,000, and not by $8,750. The difference of $1,750 is equal to the amount by which the percentage depletion for the year 1932 ($2,750) exceeds the depletion on cost for that year ($1,000) and has already been applied in the computation of earnings and profits for the year 1932 by taking into account only $1,000 instead of $2,750 for depletion in the computation of such earnings and profits (see §§ 39.115 (a)-2 and 39.115 (c)-1).

Example (2). If, in example (1), above, the property, instead of being sold, is exchanged in a transaction described in section 112 (c) for like property having a fair market value of $7,750 and cash of $7,250, then the increase in earnings and profits amounts to $7,000, that is, $15,000 ($7,750 plus $7,250) minus the basis of $8,000. However, in computing net income of the X Corporation, the gain is $8,750, that is, $15,000 minus $6,250 ($10,000 less depletion of $3,750), of which only $7,250 is recognized because the recognized gain cannot exceed the sum of money received in the transaction. See section 112 (c) (1) and the corresponding provisions of prior revenue laws. If, however, the cash received was only $2,250 and the value of the property received was $12,750, then the increase in earnings and profits would be $2,250, that amount being the gain recognized under section 112.

(d) For adjustment and allocation of the earnings and profits of the transferor as between the transferor and the transferee in cases where the transfer of property by one corporation to another corporation results in the nonrecognition in whole or in part of gain or loss, see § 39.115 (a)-3.

§ 39.115 (l)-2 *Effect on earnings and profits of receipt of tax-free distributions requiring adjustment or allocation of basis of stock.* (a) In order to deter-

mine the effect on earnings and profits, where a corporation receives (after February 28, 1913) from a second corporation a distribution which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, section 115 (l) prescribes certain rules. It provides that the amount of such distribution shall not increase the earnings and profits of the first or receiving corporation in the following cases: (1) No such increase shall be made in respect of the part of such distribution which (under the law applicable to the year in which the distribution was made) is directly applied in reduction of the basis of the stock in respect of which the distribution was made and (2) no such increase shall be made if (under the law applicable to the year in which the distribution was made) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received. Where, therefore, the law (applicable to the year in which the distribution was made, as, for example, a distribution in 1934 from earnings and profits accumulated before March 1, 1913) requires that the amount of such distribution shall be applied against and reduce the basis of the stock with respect to which the distribution was made, there is no increase in the earnings and profits by reason of the receipt of such distribution. Similarly, where there is received by a corporation a distribution from another corporation in the form of a stock dividend and the law applicable to the year in which such distribution was made requires the allocation, as between the old stock and the stock received as a dividend, of the basis of the old stock, then there is no increase in the earnings and profits by reason of the receipt of such stock dividend even though such stock dividend constitutes income within the meaning of the sixteenth amendment to the Constitution.

(b) The principles set forth in paragraph (a) of this section may be illustrated by the following examples:

Example (1). The X Corporation in 1952 distributed to the Y Corporation, one of its shareholders, $10,000 which was out of earnings or profits accumulated before March 1, 1913, and did not exceed the adjusted basis of the stock in respect of which the distribution was made. This amount of $10,000 was, therefore, a tax-free distribution and under the provisions of section 115 (b) must be applied against and reduce the adjusted basis of the stock in respect of which the distribution was made. The earnings and profits of the Y Corporation are not increased by reason of the receipt of this distribution.

Example (2). The Z Corporation in 1934 had outstanding common and preferred stock of which the Y Corporation held 100 shares of the common and no preferred. The stock had a cost basis to the Y Corporation of $100 per share, or a total cost of $10,000. In December of that year it received a dividend of 100 shares of the preferred stock of the Z Corporation. Such distribution is a stock dividend which, under section 115 (f) of the Revenue Act of 1934, was not taxable and was accordingly not included in the gross income of the Y Corporation. The original cost of $10,000 is allocated to the 200 shares of the Z Corporation none of which has been sold or otherwise disposed of by the Y Corporation. See section 113 (a) (19) and §§ 39.113 (a) (19)-1 and 39.113 (a) (12)-1. The earnings and profits of the Y Corporation are not increased by reason of the receipt of such stock dividend.

§ 39.115 (m) *Statutory provisions; distributions by corporations; earnings and profits, increase in value of property accrued before March 1, 1913.*

SEC. 115. *Distributions by corporations.* * * *

(m) *Earnings and profits; increase in value accrued before March 1, 1913.* (1) If any increase or decrease in the earnings or profits for any period beginning after February 28, 1913, with respect to any matter would be different had the adjusted basis of the property involved been determined without regard to its March 1, 1913, value, then, except as provided in paragraph (2), an increase (properly reflecting such difference) shall be made in that part of the earnings and profits consisting of increase in value of property accrued before March 1, 1913.

(2) If the application of subsection (l) to a sale or other disposition after February 28, 1913, results in a loss which is to be applied in decrease of earnings and profits for any period beginning after February 28, 1913, then, notwithstanding subsection (l) and in lieu of the rule provided in paragraph (1) of this subsection, the amount of such loss so to be applied shall be reduced by the amount, if any, by which the adjusted basis of the property used in determining the loss, exceeds the adjusted basis computed without regard to the value of the property on March 1, 1913, and if such amount so applied in reduction of the decrease exceeds such loss, the excess over such loss shall increase that part of the earnings and profits consisting of increase in value of property accrued before March 1, 1913.

[Sec. 115 (m) as added by sec. 501 (a), Second Rev. Act 1940]

§ 39.115 (m)-1 *Adjustments to earnings and profits reflecting increase in value accrued before March 1, 1913.* (a) In order to determine, for the purpose of ascertaining the source of dividend distributions, that part of the earnings and profits which is represented by increase in value of property accrued before, but realized on or after, March 1, 1913, section 115 (m) prescribes certain rules.

(b) (1) Section 115 (m) (1) sets forth the general rule with respect to computing the increase to be made in that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after, March 1, 1913.

(2) The effect of section 115 (m) (1) may be illustrated by the following examples:

Example (1). The X Corporation acquired nondepreciable property before March 1, 1913, at a cost of $10,000. Its fair market value as of March 1, 1913, was $12,000 and it was sold in 1952 for $15,000. The increase in earnings and profits based on the value as of March 1, 1913, representing earnings and profits accumulated since February 28, 1913, is $3,000. If the basis is determined without regard to the value as of March 1, 1913, there would be an increase in earnings and profits of $5,000. The difference of $2,000 ($5,000 minus $3,000) represents the increase to be made in that part of the earnings and profits of the X Corporation consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913.

Example (2). The Y Corporation acquired depreciable property in 1903 at a cost of $100,000. Assuming no additions or betterments, and that the depreciation sustained before March 1, 1913, was $10,000, the adjusted cost as of that date was $90,000. Its fair market value as of March 1, 1913, was $94,000 and on February 29, 1952, it was sold for $25,000. For the purpose of determining gain from the sale, 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 the amount of the depreciation deduction allowed after February 28, 1913, and properly allowable for each of such years to the date of the sale in 1952 is the aggregate sum of $81,467, the adjusted basis for determining gain in 1952 ($94,000 less $81,467) is $12,533 and the gain would be $12,467 ($25,000 less $12,533). The increase in earnings and profits accumulated since February 28, 1913, by reason of the sale, based on the value as of March 1, 1913, adjusted for depreciation, is $12,467. If the depreciation since February 28, 1913, had been based on the adjusted cost of $90,000 ($100,000 less $10,000) instead of the March 1, 1913, value of $94,000, the depreciation sustained from that date to the date of sale would have been $78,000 instead of $81,467 and the actual gain on the sale based on the cost of $100,000 adjusted by depreciation on such cost to $12,000 ($100,000 reduced by the sum of $10,000 and $78,000) would be $13,000 ($25,000 less $12,000). If the adjusted basis of the property was determined without regard to the value as of March 1, 1913, there would be an increase in earnings and profits of $13,000. The difference of $533 ($13,000 minus $12,467) represents the increase to be made in that part of the earnings and profits of the Y Corporation consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913.

(c) (1) Section 115 (m) (2) is an exception to the general rule in section 115 (m) (1) and also operates as a limitation on the application of section 115 (l). It provides that, if the application of (2) of the first sentence of section 115 (l) to a sale or other disposition after February 28, 1913, results in a loss which is to be applied in decrease of earnings and profits for any period beginning after February 28, 1913, then, notwithstanding section 115 (l) and in lieu of the rule provided in section 115 (m) (1) the amount of such loss so to be applied shall be reduced by the amount, if any, by which the adjusted basis of the property used in determining the loss, exceeds the adjusted basis computed without regard to the fair market value of the property on March 1, 1913. If the amount so applied in reduction of the loss exceeds such loss, the excess over such loss shall increase that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after, March 1, 1913.

(2) The application of section 115 (m) (2) may be illustrated by the following examples:

Example (1). The Y Corporation acquired nondepreciable property before March 1, 1913, at a cost of $8,000. Its fair market value as of March 1, 1913, was $13,000, and it was sold in 1952 for $10,000. Under (2) of the first sentence of section 115 (l) the adjusted basis would be $13,000 and there would be a loss of $3,000. The application of (2) of the

first sentence of section 115 (l) would result in a loss from the sale in 1952 to be applied in decrease of earnings and profits for that year. Section 115 (m) (2), however, applies and the loss of $3,000 is reduced by the amount by which the adjusted basis of $13,000 exceeds the cost of $8,000 (the adjusted basis computed without regard to the value on March 1, 1913), namely, $5,000. The amount of the loss is, accordingly, reduced from $3,000 to zero and there is no decrease in earnings and profits of the Y Corporation for the year 1952 as a result of the sale. The amount applied in reduction of the decrease, namely, $5,000, exceeds $3,000. Accordingly, as a result of the sale the excess of $2,000 increases that part of the earnings and profits of the Y Corporation consisting of increase in value of property accrued before, but realized on or after, March 1, 1913.

Example (2). The Z Corporation acquired nondepreciable property before March 1, 1913, at a cost of $10,000. Its fair market value as of March 1, 1913, was $12,000, and it was sold in 1952 for $8,000. Under (2) of the first sentence of section 115 (l) the adjusted basis would be $12,000 and there would be a loss of $4,000. The application of (2) of the first sentence of section 115 (l) would result in a loss from the sale in 1952 to be applied in decrease of earnings and profits for that year. Section 115 (m) (2), however, applies and the loss of $4,000 is reduced by the amount by which the adjusted basis of $12,000 exceeds the cost of $10,000 (the adjusted basis computed without regard to the value on March 1, 1913), namely, $2,000. The amount of the loss is, accordingly, reduced from $4,000 to $2,000 and the decrease in earnings and profits of the Z Corporation for the year 1952 as a result of the sale is $2,000 instead of $4,000. The amount applied in reduction of the decrease, namely $2,000, does not exceed $4,000. Accordingly, as a result of the sale there is no increase in that part of the earnings and profits of the Z Corporation consisting of increase in value of property accrued before, but realized on or after, March 1, 1913.

§ 39.116 *Statutory provisions; 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 chapter:

(a) *Earned income from sources without the United States*—(1) *Bona fide resident of foreign country.* In the case of an individual citizen of the United States, who establishes to the satisfaction of the Secretary that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in paragraph (3)) attributable to such period; 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 paragraph.

(2) *Presence in foreign country for 17 months.* In the case of an individual citizen of the United States, who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in paragraph (3)) attributable to such period; 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 paragraph. If the 18 month period includes the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed $20,000. If the 18 month period does not include the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed an amount which bears the same ratio to $20,000 as the number of days in the part of the taxable year within the 18 month period bears to the total number of days in such year.

(3) *Definition of earned income.* For the purposes of this subsection, "earned income" means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered, but does not include 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, under regulations prescribed by the Commissioner with the approval of the Secretary, a reasonable allowance as compensation for the personal services 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) *Teachers in Alaska and Hawaii.* [Repealed by sec. 2, Public Salary Tax Act 1939]

(c) *Income of foreign governments and of international organizations.* The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, 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 chapter 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 chapter, 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 chapter, 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 chapter) 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 chapter, 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 rate prescribed in this chapter.

(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 May 29, 1928, is to acquire a bridge—

(1) If by the terms of such contract the tax imposed by this chapter 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 chapter, 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 chapter, 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 tax imposed by this chapter) 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 chapter, accrue directly to or for the use of or to 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 chapter.

(f) *Dividend from "China Trade Act" Corporation.* In the case of a person, amounts distributed as dividends to or for his benefit by a corporation organized under the China Trade Act, 1922, 42 Stat. 849 (U. S. C., Title 15, c. 4), 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 or of the Commonwealth of the Philippines*—(1) *Rule for exclusion.* Wages, fees, or salary of any employee of a foreign government or of an international organization or of the Commonwealth of the Philippines (including a consular or other officer, or a non-diplomatic representative), received as compensation for official services

to such government, international organization, or such Commonwealth—

(A) If such employee is not a citizen of the United States, or is a citizen of the Commonwealth of the Philippines (whether or not a citizen of the United States); and

(B) If, in the case of an employee of a foreign government or of the Commonwealth of the Philippines, the services are of a character similar to those performed by employees of the Government of the United States in foreign countries or in the Commonwealth of the Philippines, as the case may be; and

(C) If, in the case of an employee of a foreign government or the Commonwealth of the Philippines, the foreign government, or the Commonwealth grants an equivalent exemption to employees of the Government of the United States performing similar services in such foreign country or such Commonwealth, as the case may be.

(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. If the Commonwealth of the Philippines grants an equivalent exemption to the employees of the United States performing services in such Commonwealth the Secretary of State shall certify such fact to the Secretary of the Treasury and the character of the services performed by employees of the Government of the United States in such Commonwealth.

(i) *Treasury bills.* For exemption from taxation of gain derived from the sale or other disposition of Treasury Bills, issued after June 17, 1930, under the second Liberty bond act, as amended, see act of June 17, 1930, c. 512, 46 Stat. 775 (U. S. C., Title 31, sec. 754).

(j) In the case of a clerk or employee in the Foreign Service of the United States, amounts received as cost-of-living allowances under authority of section 3, as amended; of the act of February 23, 1931; and in the case of an ambassador, minister, diplomatic, consular, or Foreign Service officer, amounts received as post allowances under the authority of section 12, as amended and renumbered, of the act of May 24, 1924; and in the case of other civilian officers or employees of the Government of the United States stationed outside continental United States, amounts received as cost-of-living allowances in accordance with regulations approved by the President.

(k) In the case of an officer or employee of the Foreign Service of the United States, amounts received by such officer or employee as allowances or otherwise under the terms of title IX of the Foreign Service Act of 1946.

(l) *Income from sources within Puerto Rico*—(1) *Resident of Puerto Rico for entire taxable year.* In the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, income derived from sources within Puerto Rico (except amounts received for services performed as an employee of the United States or any agency thereof); 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 paragraph.

(2) *Taxable year of change of residence from Puerto Rico.* In the case of an individual citizen of the United States, who has been a bona fide resident of Puerto Rico for a period of at least two years before the date on which he changes his residence from Puerto Rico, income derived from sources therein (except amounts received from services performed as an employee of the United States or any agency thereof) which is attributable to that part of such period of Puerto Rican residence before such date; 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 paragraph.

[Sec. 116 as amended by sec. 2, Public Salary Tax Act 1939; secs. 148 (a), and 149 (a), Rev. Act, 1942; secs. 107 and 125 (a), Rev. Act 1943; sec. 4, Pub. Law 291 (79th Cong.); sec. 1051, Foreign Service Act 1946; sec. 221 (c), Rev. Act 1950; sec. 321 (a), Rev. Act 1951; sec. 204 (a) and (c), Technical Changes Act 1953]

§ 39.116–1 *Earned income from sources without the United States*—(a) *Resident of a foreign country.* (1) Amounts constituting earned income as defined in section 116 (a) (3) shall be excluded from gross income in the case of an individual citizen of the United States who establishes to the satisfaction of the Commissioner that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, if such amounts are (i) from sources without the United States, (ii) attributable to such uninterrupted period, and (iii) not paid by the United States or any agency or instrumentality thereof. The exemption from tax thus provided is applicable to such amounts as are attributable to that portion of an uninterrupted period of bona fide foreign residence which falls within a taxable year during the course of which the citizen begins or terminates bona fide residence in a foreign country, provided that such period includes at least one entire taxable year. If attributable to an uninterrupted period in respect of which the citizen qualifies for the exemption from tax thus provided, the amounts shall be excluded from gross income irrespective of when they are received. The period during which the citizen was a bona fide resident of a foreign country or countries prior to the commencement of his first taxable year beginning after December 31, 1951, may be taken into account in determining whether such citizen has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year.

(2) Though the period of bona fide foreign residence must be continuous and uninterrupted, once bona fide residence in a foreign country or countries has been established, temporary visits to the United States or elsewhere on vacation or business trips will not necessarily deprive the citizen of his status as a bona fide resident of a foreign country. Whether the individual citizen of the United States is a bona fide resident of a foreign country shall be determined by the application, to the extent feasible, of the principles of §§ 39.211–2, 39.211–3, 39.211–4, and 39.211–5, relating to what constitutes residence or nonresidence, as the case may be, in the United States in the case of an alien individual.

(3) In any case in which any amount otherwise constituting gross income is excluded from gross income under the provisions of section 116 (a), there shall not be allowed as a deduction from gross income any items of expenses or losses or other deductions properly applicable to or chargeable against the amounts so excluded from gross income. The apportionment and allocation of such expenses, losses, or deductions as between income from sources within, and income from sources without, the United States shall be determined in accordance with the principles of section 119 and the regulations thereunder.

(4) 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 patients or clients are those of the taxpayer and look to the taxpayer as the person responsible for the services performed.

(5) 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.

(6) An amount constituting earned income as defined in section 116 (a) (3) which is derived from sources without the United States shall not be included in gross income solely because it is received within the United States, since the place of receipt is immaterial in determining whether any items shall be excluded from gross income under the provisions of section 116 (a) No amounts received for services performed within the United States shall be excluded from gross income by such section. For the allocation or segregation as between sources within, and sources without, the United States in the case of compensation for labor or personal services, see section 119 and the regulations thereunder.

(7) Any return filed before the completion of the period necessary to qualify a citizen for the exemption under section 116 (a) shall be filed without regard to the exemption provided by that section, but claim for credit or refund of any overpayment of tax may be filed if the taxpayer subsequently qualifies for the exemption under section 116 (a) A taxpayer desiring an extension of time (in addition to that granted by § 39.53–3) for filing the return until after the completion of the qualifying period under section 116 (a) shall make application therefor with the district director of internal revenue, setting forth the facts relied upon to justify the extension of time requested and including a statement as to the earliest date he expects to be in a position to determine whether he

will be entitled to the exclusion provided by section 116 (a) An extension of time may be granted for more than 6 months in the case of taxpayers who are abroad. For extensions of time for filing returns, see section 53 (a) (2) and § 39.53-2.

(8) In estimating his gross income for the purpose of making a declaration of estimated tax for any taxable year, a citizen of the United States is not required to take into account income which it is reasonable to believe will be excluded from gross income under the provisions of section 116 (a) and the regulations thereunder.

(9) The term "foreign country" means territory under the sovereignty of a government other than that of the United States. It does not include a possession or territory of the United States.

(b) *Presence in a foreign country.* (1) Amounts constituting earned income as defined in section 116 (a) (3) shall be excluded from gross income in the case of an individual citizen of the United States who during any period of 18 consecutive months is present in a foreign country or countries during a total of at least 510 full days, if such amounts are (i) from sources without the United States, (ii) attributable to such period, and (iii) not paid by the United States or any agency or instrumentality thereof. If attributable to a period of 18 consecutive months in respect of which the citizen qualifies for the exemption from tax thus provided, the amounts shall be excluded from gross income irrespective of when they are received.

(2) For taxable years ending before January 1, 1953, there is no limitation upon the amount which may be excluded from gross income pursuant to subparagraph (1) For taxable years ending after December 31, 1952, but only with respect to amounts received after such date, the amount excluded from gross income under the provisions of section 116 (a) (2) shall not exceed $20,000 if the 18-month period includes the entire taxable year. If the 18-month period does not include the entire taxable year, the amount excluded from gross income under such section for such taxable year shall not exceed an amount which bears the same ratio to $20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year. In the case of a fiscal year beginning in 1952 and ending in 1953 the exclusion of amounts received after December 31, 1952, shall not exceed the lesser of the amount determined under the two preceding sentences or an amount which is the same proportion of $20,000 as the number of days in such taxable year after such date is of 365 days. There is no limitation as to the total amount of the exclusion for amounts received prior to January 1, 1953, in the case of such a fiscal year.

(3) The period during which the citizen was present in a foreign country or countries before the commencement of his first taxable year beginning after December 31, 1951, may be taken into account in determining whether such citizen is present in a foreign country or countries during at least 510 full days during any period of 18 consecutive months.

(4) Any return filed before the completion of the period necessary to qualify a citizen for the exemption under section 116 (a) shall be filed without regard to the exemption provided by that section, but claim for credit or refund of any overpayment of tax may be filed if the taxpayer subsequently qualifies for the exemption under section 116 (a) A taxpayer desiring an extension of time (in addition to that granted by § 39.53-3) for filing the return until after the completion of the qualifying period under section 116 (a) shall make application therefor with the district director of internal revenue, setting forth the facts relied upon to justify the extension of time requested and including a statement as to the earliest date he expects to be in a position to determine whether he will be entitled to the exclusion provided by section 116 (a) An extension of time may be granted for more than 6 months in the case of taxpayers who are abroad. For extensions of time for filing returns, see section 53 (a) (2) and § 39.53-2.

(5) In estimating his gross income for the purpose of making a declaration of estimated tax for any taxable year, a citizen of the United States is not required to take into account income which it is reasonable to believe will be excluded from gross income under the provisions of section 116 (a) and the regulations thereunder.

(6) The provisions of paragraph (a) of this section respecting the disallowance of certain deductions, the definition of earned income, the source of income, and the immateriality of the place of receipt of amounts constituting earned income are equally effective in the application of this paragraph.

(7) The term "foreign country" means territory under the sovereignty of a government other than that of the United States and includes the air space over such territory. It does not include a possession or territory of the United States.

(8) The exclusion provided by section 116 (a) (2) applies to income attributable to any period of 18 consecutive months during which the citizen satisfies the 510 full-day requirement, even though such period constitutes a part of a longer period of presence in a foreign country or countries. For this purpose, the term "18 consecutive months" means any period of such duration, that is, any period commencing with the beginning of any day of a calendar month and terminating (i) with the close of the day which precedes that day in the eighteenth succeeding calendar month numerically corresponding to the day of the period's beginning, or, if there is no such corresponding day, (ii) with the close of the last day of such eighteenth succeeding month. Such period need not necessarily commence with the day of arrival in a foreign country nor terminate with the day of departure therefrom. In no event will the 510 full-day requirement be prorated over a period of less than 18 consecutive months.

(9) Thus, a citizen who arrives in a foreign country on January 1, 1952, makes several return trips to the United States, and then finally departs from the foreign country on February 14, 1954, may not be present in such country for 510 full days during the 18-month period commencing with January 1, 1952, and ending with the close of June 30, 1953, because of his visits to the United States during such period, but may satisfy the 510 full-day requirement during the 18-month period commencing with February 15, 1952, and ending with the close of August 14, 1953. In such event, the exclusion will apply to income attributable to the latter period, but not to income attributable to the period commencing with January 1, 1952, and ending with the close of February 14, 1952. For such purpose, it is assumed that no part of the period ending with the close of February 14, 1952, is included in any 18-month period during which the 510 full-day requirement is satisfied. Furthermore, the mere fact that the 510 full-day requirement has been satisfied with respect to the period ending with the close of August 14, 1953, does not mean that income earned thereafter will be excluded under section 116 (a) (2) unless such income is attributable to another 18-month period during which there is compliance with the 510 full-day requirement. Thus, the 510 full-day requirement cannot be prorated over the 6-month period commencing with August 15, 1953, and ending with the close of February 14, 1954, in order to determine whether the exclusion allowed by section 116 (a) (2) applies to income attributable to such 6-month period. Therefore, assuming that the citizen is present in the foreign country 170 full days (1/3 of 510 full days) during such 6-month period (1/3 of 18 consecutive months), the exclusion will not be applicable to income attributable to any part of such 6-month period if no part thereof is included in any 18-month period during which the 510 full-day requirement is satisfied.

(10) The term "full day" means, not any 24-consecutive-hour period, but a continuous period of twenty-four hours commencing from midnight and ending with the following midnight. In computing the minimum of 510 full days of presence in a foreign country or countries, all separate periods of such presence during the period of 18 consecutive months are to be aggregated. The 510 full days need not be consecutive, but may be interrupted by a number of short periods during which the citizen is not present in a foreign country. Time spent in a foreign country in the employment of the United States Government will count toward satisfaction of the 510 full-day requirement, even though amounts paid by such Government are not exempt from tax under section 116 (a) (2)

(11) In each of the following examples it is assumed that the facts are such that the limitations upon the amount to be excluded, which were added by section

204 of the Technical Changes Act of 1953, are not applicable.

Example (1). On February 1, 1953, Mr. White, a citizen of the United States privately employed, arrived in Puerto Rico on a business assignment. Upon completion of the assignment he departed for a new assignment in Venezuela. On June 1, 1953, at 9 a. m. he arrived in Venezuela, where he remained until 2 p. m. on October 25, 1954, at which time he departed for another assignment in Puerto Rico. On January 10, 1955, he left Puerto Rico for a new assignment in the United States. During the 18-month period commencing with April 25, 1953, and ending with the close of October 24, 1954, the taxpayer was in a foreign country an aggregate of 510 full days; in addition, during the 18-month period commencing with June 2, 1953, and ending with the close of December 1, 1954, he was in a foreign country an aggregate of 510 full days. The exemption from tax granted by section 116 (a) (2) will thus apply to income attributable to the entire period which commences with April 25, 1953, and ends with the close of December 1, 1954, a period of approximately 19 consecutive months.

Example (2). At 2 p. m. on January 18, 1952, Mr. Brown, a citizen of the United States privately employed, arrived in England on a business trip from the United States. On May 19, 1952, at 10 p. m. he departed from England by steamer and arrived in the United States on May 25, 1952. After spending a period therein on official business, he left the United States by steamer on June 9, 1952, and arrived in France at 3 p. m., June 14, 1952. At 8 a. m. on February 3, 1953, he departed from France by airplane for a brief visit to Puerto Rico, arriving there on February 4; and thence went to England, arriving there at 1 a. m. on February 12, 1953, where he remained until midnight, July 18, 1953, at which time the 510 full-day requirement was satisfied in respect of the period of 18 consecutive months which began with January 19, 1952. Mr. Brown continued his presence in England, not leaving such country until 5 a. m. on November 18, 1953, at which time he departed for the United States. During the 18-month period commencing with January 19, 1952, and ending with the close of July 18, 1953, the taxpayer was in a foreign country or countries an aggregate of 510 full days; in addition, during the 18-month period commencing with June 16, 1952, and ending with the close of December 15, 1953, he was in a foreign country or countries an aggregate of 510 full days. The exemption from tax granted by section 116 (a) (2) will thus apply to income attributable to the entire period which commences with January 19, 1952, and ends with the close of December 15, 1953. The computation with respect to each period may be illustrated as follows:

	Full days in foreign country
First 18-month period (1-19-52 through 7-18-53)	
1-19-52 to 5-18-52	121
5-19-52 to 6-14-52	0
6-15-52 to 2-2-53	233
2-3-53 to 2-12-53	0
2-13-53 to 7-18-53	156
Total full days	510
Second 18-month period (6-16-52 through 12-15-53).	
6-16-52 to 2-2-53	232
2-3-53 to 2-12-53	0
2-13-53 to 11-17-53	278
11-18-53 to 12-15-53	0
Total full days	510

Example (3). On March 6, 1952, at 3 p. m. Mr. Green, a citizen privately employed, arrived in Cuba where he remained until 9 p. m., June 25, 1952, at which time he departed from Cuba for a short business trip to Puerto Rico. Upon completion of his negotiations in that possession, he departed for Mexico, arriving there at 2 p. m. on July 24, 1952, where he remained until 10 a. m., August 22, 1953, at which time he departed from such country for a vacation in the United States. He arrived again in Mexico at 9 a. m. on September 5, 1953, where he remained until 8 a. m., January 1, 1954, at which time he departed from such country for a new assignment in the United States. During the 18-month period commencing with March 7, 1952, and ending with the close of September 6, 1953, the taxpayer was in a foreign country or countries an aggregate of 504 full days; during the 18-month period commencing with July 1, 1952, and ending with the close of December 31, 1953, he was in a foreign country an aggregate of 510 full days. The exemption from tax granted by section 116 (a) (2) will thus not apply to income attributable to any part of the period beginning with March 6, 1952, and ending with the close of June 30, 1952; it will apply to income attributable to the period commencing with July 1, 1952, and ending with the close of December 31, 1953. The computation with respect to each period may be illustrated as follows:

	Full days in foreign country
First 18-month period (3-7-52 through 9-6-53)	
3-7-52 to 6-24-52	110
6-25-52 to 7-24-52	0
7-25-52 to 8-21-53	393
8-22-53 to 9-5-53	0
9-6-53	1
Total full days	504
Second 18-month period (7-1-52 through 12-31-53)	
7-1-52 to 7-24-52	0
7-25-52 to 8-21-53	393
8-22-53 to 9-5-53	0
9-6-53 to 12-31-53	117
Total full days	510

§ 39.116-2 *Income of foreign governments, international organizations, and their employees*—(a) *Foreign governments and their employees.* (1) 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.

(2) 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 to such foreign government, provided (i) the services are of a character similar to those performed by employees of the Government of the United States in such foreign country and (ii) 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 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)

(b) *International organizations and their employees.* (1) Subject to the provisions of section 1 of the International Organizations Immunities Act (22 U. S. C. 288), the income of an international organization (as defined in section 3797 (a) (18)) received from investments in the United States in stocks, bonds, or other domestic securities, owned by such international organization, or from interest on deposits in banks in the United States of moneys belonging to such international organizations, or from any other source within the United States, is exempt from Federal income tax. An organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act (22 U. S. C. 288-288f) may enjoy the benefits of the exemption with respect to income of the prescribed character received by such organization before the date of the issuance of such Executive order, if (i) the Executive order does not provide otherwise and (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an Act of Congress authorizing such participation or making an appropriation for such participation, at the time such income is received.

(2) Subject to the provisions of sections 1, 8, and 9 (22 U. S. C. 288, 288e, and 288f) of the International Organizations Immunities Act, wages, fees, or salary of any officer or employee of an international organization (as defined in section 3797 (a) (18)) received as compensation for official services to such international organization is exempt from Federal income tax, if such officer or employee is not a citizen of the United States. An individual of the prescribed class who receives wages, fees, or salary as compensation for official services to an organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act and who has been duly notified to and accepted by the Secretary of State as an officer or employee of such organization, or who has been designated by the Secretary of State, prior to formal notification and

acceptance, as a prospective officer or employee of such organization, may enjoy the benefits of the exemption with respect to compensation of the prescribed character earned by such individual either before the date of the issuance of such Executive order, or before the date of such acceptance or designation by the Secretary of State, for official services to such organization, if (i) the Executive order does not provide otherwise, (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an Act of Congress authorizing such participation or making an appropriation for such participation, at the time such compensation is earned, and (iii) the individual is an officer or employee of such organization at such time. The compensation of citizens of the United States who are officers or employees of an international organization is not exempt from income tax. But see section 116 (a)

(3) Sections 1, 8, and 9 of the International Organizations Immunities Act provide in part as follows:

SECTION 1. For the purposes of this title [International Organizations Immunities Act], the term "international organization" means a public international organization in which the United States participates pursuant to any treaty or under the authority of any Act of Congress authorizing such participation or making an appropriation for such participation, and which shall have been designated by the President through appropriate Executive order as being entitled to enjoy the privileges, exemptions, and immunities herein provided. The President shall be authorized, in the light of the functions performed by any such international organization, by appropriate Executive order to withhold or withdraw from any such organization or its officers or employees any of the privileges, exemptions, and immunities provided for in this title (including the amendments made by this title) or to condition or limit the enjoyment by any such organization or its officers or employees of any such privilege, exemption, or immunity. The President shall be authorized, if in his judgment such action should be justified by reason of the abuse by an international organization or its officers and employees of the privileges, exemptions, and immunities herein provided or for any other reason, at any time to revoke the designation of any international organization under this section, whereupon the international organization in question shall cease to be classed as an international organization for the purposes of this title.

SEC. 8. (a) No person shall be entitled to the benefits of this title [International Organizations Immunities Act] unless he (1) shall have been duly notified to and accepted by the Secretary of State as a * * * officer, or employee; or (2) shall have been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective * * * officer, or employee; * * *

(b) Should the Secretary of State determine that the continued presence in the United States of any person entitled to the benefits of this title is not desirable, he shall so inform the * * * international organization concerned * * * and after such person shall have had a reasonable length of time, to be determined by the Secretary of State, to depart from the United States, he shall cease to be entitled to such benefits.

(c) No person shall, by reason of the provisions of this title, be considered as receiving diplomatic status or as receiving any of the privileges incident thereto other than such as are specifically set forth herein.

SEC. 9. The privileges, exemptions, and immunities of international organizations and of their officers and employees * * * provided for in this title [International Organizations Immunities Act], shall be granted notwithstanding the fact that the similar privileges, exemptions, and immunities granted to a foreign government, its officers, or employees, may be conditioned upon the existence of reciprocity by that foreign government: *Provided*, That nothing contained in this title shall be construed as precluding the Secretary of State from withdrawing the privileges, exemptions, and immunities herein provided from persons who are nationals of any foreign country on the ground that such country is failing to accord corresponding privileges, exemptions, and immunities to citizens of the United States.

§ 39.116-3 *Bridges to be acquired by State or political subdivisions.* (a) 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 chapter 1, shall file a claim therefor on Form 843 (to which there shall be attached as exhibits the matter hereinafter prescribed) with the district director of internal revenue for the internal revenue 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:

(1) 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;

(2) A full statement of the facts considered by the claimant sufficient to entitle it to receive 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)

(3) 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

(4) A statement, verified by a written declaration that it is made under the penalties of perjury, made by or on behalf of the taxpayer 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.

(b) 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 section is not considered an overpayment within the meaning of section 3771, relating to interest on overpayments, and no interest shall be allowed or paid upon the amount of the refund.

(c) 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 (a) (3) of this section, 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 section 116 (e) and this section.

§ 39.116-4 *Exclusion of certain cost-of-living allowances.* (a) Amounts received by Government civilian personnel stationed outside the continental United States as cost-of-living or post allowances in accordance with regulations approved by the President are, by the provisions of section 116 (j), excluded from gross income. Such allowances shall be considered as retaining their characteristics under section 116 (j) notwithstanding any possible combination thereof with any other allowance, such as a quarters allowance, as, for example, in a "living and quarters allowance," whether or not such other allowance is excluded from gross income.

(b) For the purposes of section 116 (j) the term "continental United States" includes only the States of the Union and the District of Columbia.

§ 39.116-5 *Exclusion of certain allowances of Foreign Service personnel.* Amounts received by personnel of the Foreign Service of the United States as allowances or otherwise under the terms of title IX of the Foreign Service Act of 1946 (22 U. S. C. 1131 et seq.) are, by the provisions of section 116 (k), excluded from gross income.

§ 39.116-6 *Exclusion of certain income from sources within Puerto Rico.* (a) There is excluded from gross income in the case of an individual (whether a citizen of the United States or an alien) who is a bona fide resident of Puerto Rico during the entire taxable year income derived from sources within Puerto Rico, except such income as consists of amounts received for services performed as an employee of the United States or any agency thereof. Whether the individual is a bona fide resident of Puerto Rico shall be determined in general by applying to the facts and circumstances in each case the principles of §§ 39.211-2, 39.211-3, 39.211-4, and 39.211-5, relating to what constitutes residence or nonresidence, as the case may be, in the United States in the case of an alien individual. Once bona fide residence in Puerto Rico has been established, temporary absence therefrom in the United States or elsewhere on vacation or business trips will not necessarily deprive an individual of his status as a bona fide resident of Puerto Rico. An individual taking up residence in Puerto Rico during the course of the taxable year is not entitled for such year to the exclusion provided in section 116 (l)

(b) There is excluded from gross income, in the case of an individual citizen of the United States who during such taxable year changes his residence from Puerto Rico to a place outside Puerto Rico after having been a bona fide resident of Puerto Rico for a period of at least two years immediately preceding the date of such change in residence, income derived from sources within Puerto Rico which is attributable to that part of such period of Puerto Rican residence which precedes the date of such change in residence, except such income as consists of amounts received for services performed as an employee of the United States or any agency thereof.

(c) In any case in which any amount otherwise constituting gross income is excluded from gross income under the provisions of section 116 (l) there shall not be allowed as a deduction from gross income any items of expenses or losses or other deductions properly allocable to, or chargeable against, the amounts so excluded from gross income. The apportionment and allocation of such expenses, losses, or deductions as between income from sources within Puerto Rico and income from other sources shall be determined in accordance with the principles of section 119 and the regulations thereunder.

§ 39.117 (a) *Statutory provisions; capital gains and losses; definitions.*

SEC. 117. *Capital gains and losses*—(a) *Definitions.* As used in this chapter—

(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—

(A) 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;

(B) Property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), or real property used in his trade or business;

(C) A copyright; a literary, musical, or artistic composition; or similar property; held by—

(i) A taxpayer whose personal efforts created such property, or

(ii) A taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

(D) An obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

(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 6 months, if and to the extent such gain is taken into account in computing gross 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 6 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 6 months, if and to the extent such gain is taken into account in computing gross 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 6 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 short-term capital losses for such year;

(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.

(10) *Net capital gain*—(A) *Corporations.* In the case of a corporation, the term "net capital gain" means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges; and

(B) *Other taxpayers.* In the case of a taxpayer other than a corporation, the term "net capital gain" means the excess of (i) the sum of the gains from sales or exchanges of capital assets, plus net income of the taxpayer or $1,000, whichever is smaller, over (ii) the losses from such sales or exchanges. For purposes of this subparagraph, net income shall be computed without regard to gains or losses from sales or exchanges of capital assets. If the tax is to be computed under Supplement T, "net income" as used in this subparagraph shall be read as "adjusted gross income"

(11) *Net capital loss.* The term "net capital loss" means the excess of the losses from sales or exchanges of capital assets over the sum allowed under subsection (d). For the purpose of determining losses under this paragraph, amounts which are short-term capital losses under subsection (e) (1) shall be excluded.

[Sec. 117 (a) as amended by sec. 115 (b), Rev. Act 1941; secs. 150 (a) (b), 151 (a), Rev. Act 1942; sec. 8 (d) (1), Individual Income Tax Act 1944; sec. 210 (a), Rev. Act 1950; sec. 322 (c) (2), Rev. Act 1951]

§ 39.117 (a)-1 *Meaning of terms.* (a) 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.

(b) 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) and of real property used in the trade or business of a taxpayer is limited to such property used by the taxpayer in the trade or business at the time of the sale, exchange, or involuntary conversion. Gains and losses from the sale or exchange of such property are not treated as gains and losses from the sale or exchange of capital assets, except to the extent provided in section 117 (j) See § 39.117 (j)-1. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term "capital assets" even though depreciation may have been allowed with respect to such property under section 23 (l) before its amendment by section 121 (c) of the Revenue Act of 1942. However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the provisions of section 117. The term "ordinary net income," as used in the regulations in this part for the purposes of section 117, means net income exclusive of gains and losses from the sale or exchange of capital assets.

(c) A copyright, a literary, musical, or artistic composition, and similar property are excluded from the term "capital assets" if held by a taxpayer whose personal efforts created such property, or if held by a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property. As to the application of section 117 (j) to the sale or exchange of such property held by such a taxpayer, see § 39.117 (j)-1. The phrase "similar property" includes, for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law) but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.

(d) Obligations of the United States or any of its possessions, or of a State or

Territory or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term "capital assets." An obligation may be issued on a discount basis even though the price paid exceeds the face amount. Thus, although the Second Liberty Bond Act (31 U. S. C. 754) provides that United States Treasury bills shall be issued on a discount basis, the issuing price paid for a particular bill may, by reason of competitive bidding, actually exceed the face amount of the bill. Since the obligations of the type described in this paragraph are excluded from the term "capital assets," gains or losses from the sale or exchange of such obligations are not subject to the limitations provided in section 117. It is, therefore, not necessary for a taxpayer, other than a life insurance company subject to taxation only on interest, dividends, and rents, to segregate the original discount accrued (see § 39.42–7) and the gain or loss realized upon the sale or other disposition of any such obligation.

Example (1). A (not a life insurance company) buys a $100,000 90-day Treasury bill upon issuance for $99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for $99,999.50. The entire net gain to A of $1.50 may be taken into account as a single item of income, without allocating $1 to interest and $0.50 to gain. If B holds the bill until maturity his net gain of $0.50 may similarly be taken into account as a single item of income, without allocating $1 to interest and $0.50 to loss.

Example (2). The facts in this example are the same as in example (1) except that the selling price to B is $99,998.50. The net gain to A of $0.50 may be taken into account without allocating $1 to interest and $0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of $1.50 may be taken into account as a single item of income without allocating $1 to interest and $0.50 to gain.

(e) The phrase "short-term" applies to the category of gains and losses arising from the sale or exchange of capital assets held for six 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 six months. The fact that some part of a loss from the sale or exchange of a capital asset may be finally disallowed because of the operation of section 117 (d) 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) and (5)

(f) In the definition of "net short-term capital gain," as provided in section 117 (a) (6) the amounts brought forward to the taxable year under section 117 (e) are short-term capital losses for such taxable year.

(g) Gains and losses from the sale or exchange of capital assets held for not more than six 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 six months (described as long-term capital gains and long-term capital losses)

(h) In the case of a corporation, the term "net capital gain" means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges, which losses include any amounts brought forward pursuant to section 117 (e) In the case of a taxpayer other than a corporation, the term "net capital gain" means the excess of (1) the sum of the gains from sales or exchanges of capital assets, plus net income (computed without regard to gains and losses from sales or exchanges of capital assets) of the taxpayer or $1,000, whichever is smaller, over (2) the losses from such sales or exchanges, which losses include amounts brought forward under section 117 (e) In the case of a taxpayer whose tax liability is computed under Supplement T, the term "net income," as used in the preceding sentence, shall be read as "adjusted gross income." For application of the term "net capital gain," in computing the capital loss carry-over under section 117 (e) see paragraph (c) of § 39.117 (b)–1.

(i) The term "net capital loss" means the excess of the losses from sales or exchanges of capital assets over the sum allowed under section 117 (d) However, amounts which are short-term capital losses under section 117 (e) (1) are excluded in determining such "net capital loss."

(j) 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. See also section 117 (j) and § 39.117 (j)–1 for the determination of whether or not gains and losses from the involuntary conversion of capital assets and from the sale, exchange, or involuntary conversion of certain property used in the trade or business shall be treated as gains and losses from the sale or exchange of capital assets. See also section 117 (n) and § 39.117 (n)–1 for the determination of whether or not gains from the sale or exchange of securities by a dealer in securities shall be treated as capital gains, or whether losses from such sales or exchanges shall be treated as ordinary losses.

(k) In the case of nonresident alien individuals not engaged in trade or business within the United States, see section 211 and the regulations thereunder for the determination of the net amount of capital gains subject to tax.

§ 39.117 (b) *Statutory provisions; capital gains and losses; deduction from gross income.*

SEC. 117. *Capital gains and losses.* * * * (b) *Deduction from gross income.* In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 per centum of the amount of such excess shall be a deduction from gross income. In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains for the taxable year from sales or exchanges of capital assets, which, under section 162 (b) or (c), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

[Sec. 117 (b) as amended by sec. 150 (c), Rev. Act 1942; sec. 322 (a) (2), Rev. Act 1951]

§ 39.117 (b)–1 *Deduction for long-term capital gains.* (a) In computing gross income, adjusted gross income, net income, net capital gain, and net capital loss, 100 percent of any gain or loss (computed under section 111, recognized under section 112, and taken into account without regard to section 117) upon the sale or exchange of a capital asset shall be taken into account regardless of the period for which the capital asset has been held. Nevertheless, the net short-term capital gain or loss and the net long-term capital gain or loss must be separately computed. In computing the adjusted gross income or the net income of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of the excess is allowable as a deduction from gross income under sections 23 (ee) and 117 (b) For instance, if an individual realizes $2,000 of long-term capital gain and sustains $1,500 of short-term capital loss during the taxable year, the whole amount of the gain ($2,000) is includible in gross income. Since the net long-term capital gain exceeds the net short-term capital loss by $500, 50 percent of the excess ($250) is allowable as a deduction under section 23 (ee) and 117 (b)

(b) In the case of an estate or trust, for the purpose of computing the deduction allowable under sections 23 (ee) and 117 (b) any long-term or short-term capital gains which, under section 162 (b) or (c) are includible in the gross income of its income beneficiaries as gains derived from the sale or exchange of capital assets must be excluded in determining whether, for the taxable year of the estate or trust, its net long-term capital gain exceeds its net short-term capital loss. For example, during 1952 a trust realized a gain of $1,000 upon the sale of stock held for 10 months. Under the terms of the trust instrument all of such gain must be distributed not later than 30 days after the close of the year to A, the sole income beneficiary. The trust is not entitled to any deduction with respect to such gain under sections 23 (ee) and 117 (b) On the other hand, assuming A had no other capital gains or losses in 1952, he would be entitled to a deduction of $500.

§ 39.117 (c) *Statutory provisions; capital gains and losses; alternative taxes.*

SEC. 117. *Capital gains and losses.* * * * (c) *Alternative taxes*—(1) *Corporations.* If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 13, 14, 15, 204, 207 (a) (1) or (3), 421, and 500, a tax determined

as follows, if and only if such tax is less than the tax imposed by such sections:

(A) A partial tax shall first be computed upon the net income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted.

(B) There shall then be ascertained an amount equal to 25 per centum of such excess, except that in the case of any taxable year beginning after March 31, 1951, and before April 1, 1954, there shall be ascertained an amount equal to 26 per centum of such excess.

(C) The total tax shall be the partial tax computed under subparagraph (A) plus the amount computed under subparagraph (B).

(2) *Other taxpayers.* If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12 (or, in the case of certain tax-exempt trusts, in lieu of the tax imposed by section 421), a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

(A) A partial tax shall first be computed upon the net income reduced by an amount equal to 50 per centum of such excess, at the rates and in the manner as if this subsection had not been enacted.

(B) There shall then be ascertained an amount equal to 25 per centum of the excess of the net long-term capital gain over the net short-term capital loss. In the case of any taxable year beginning after October 31, 1951, and before November 1, 1953, there shall be ascertained, in lieu of the amount computed under the preceding sentence, an amount equal to 26 per centum of the excess of the net long-term capital gain over the net short-term capital loss.

(C) The total tax shall be the partial tax computed under subparagraph (A) plus the amount computed under subparagraph (B).

[Sec. 117 (c) as amended by sec. 150 (c), Rev. Act 1942; sec. 301 (c) (2) (3), Rev. Act 1950; secs. 123 and 322 (b), Rev. Act 1951]

§ 39.117 (c)-1 *Alternative tax in case net long-term capital gain exceeds net short-term capital loss.* (a) In case the net long-term capital gain of a taxpayer (other than a corporation) exceeds the net short-term capital loss, section 117 (c) (2) imposes an alternative tax in lieu of the tax imposed by sections 11 and 12 (or, in the case of certain tax-exempt trusts, the tax imposed by section 421) if and only if such alternative tax is less than the tax imposed by sections 11 and 12 (or, in the case of certain tax-exempt trusts, the tax imposed by section 421) This alternative tax is the sum of (1) a partial tax, computed at the rates provided by sections 11 and 12 (or, in the case of certain tax-exempt trusts, the tax imposed by section 421) on the net income reduced by an amount equal to 50 percent of the excess of the net long-term capital gain (determined by taking into account 100 percent of the gains and losses upon the sale or exchange of capital assets held for more than six months) over the net short-term capital loss, plus (2) 25 percent (26 percent if the taxable year begins before November 1, 1953) of the excess of the net long-term capital gain over the net short-term capital loss.

(b) In case the net long-term capital gain of any corporation exceeds the net short-term capital loss, section 117 (c) (1) imposes an alternative tax in lieu of the tax imposed by sections 13, 15, 204, 207 (a) (1) or (3) 421, and 500, if and only if such alternative tax is less than the tax imposed by such sections. This alternative tax is the sum of (1) a partial tax computed at the rates provided by sections 13, 15, 204, 207 (a) (1) or (3) 421, and 500 on the net income of the taxpayer, excluding therefrom for this purpose the amount of such excess of the net long-term capital gain over the net short-term capital loss, plus (2) 25 percent (26 percent if the taxable year begins before April 1, 1954) of such excess.

(c) In applying section 117 (c) in the case of tax-exempt trusts or organizations subject to the tax imposed by section 421, the only amount which is taken into account as capital gain or loss is that which is taken into account in computing unrelated business net income under section 422. Under section 422, the only amount taken into account as capital gain or loss is that resulting from the application of section 117 (k) (1).

(d) In the case of a joint return made by husband and wife, the excess of any net long-term capital gain over any net short-term capital loss is to be determined by combining the long-term capital gains and losses and the short-term capital gains and losses of the spouses.

(e) The following example illustrates the application of the provisions of section 117 (c) and of this section in the case of an individual taxpayer:

Example. A, a single individual, has for the calendar year 1952 an ordinary net income of $100,000. He is entitled to one exemption of $600. He realizes in 1952 a gain of $50,000 on the sale of a capital asset held for 19 months and sustains a loss of $20,000 on the sale of a capital asset held for five months. Since the alternative tax is less than the tax otherwise computed under sections 11 and 12, the tax payable is the alternative tax, that is, $77,438. The tax is computed as follows:

Tax under sections 11 and 12

Ordinary net income		$100,000
Net long-term capital gain (100 percent of $50,000)	$50,000	
Net short-term capital loss (100 percent of $20,000)	20,000	
Excess of net long-term capital gain over the net short-term capital loss		30,000
		130,000
Deduction of 50 percent of excess of net long-term capital gain over the net short-term capital loss		15,000
Net income		115,000
Less exemption		600
Income subject to normal tax and surtax		114,400
Combined normal tax and surtax under sections 11 and 12		83,176

Alternative tax under section 117 (c) (2)

Net income	$115,000
Less 50 percent of excess of net long-term capital gain over net short-term capital loss	15,000
Ordinary net income	100,000
Less exemption	600
Income subject to normal tax and surtax	99,400
Partial tax (combined normal tax and surtax on $99,400)	69,638
Plus 26 percent of $30,000	7,800
Total alternative tax under section 117 (c) (2)	77,438

(f) On amounts received or accrued from the disposal of coal to which the provisions of section 117 (k) (2) are applicable, the computation under section 117 (c) (1) of a tax in lieu of the tax imposed by section 500 shall be made without regard to section 117 (k) (2) that is, the partial tax under section 117 (c) (1) (A) insofar as it involves the tax under section 500, is computed without regard to section 117 (k) (2)

§ 39.117 (d) *Statutory provisions; capital gains and losses; limitation on capital losses.*

SEC. 117. *Capital gains and losses.* * * *

(d) *Limitation on capital losses*—(1) *Corporation.* In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges.

(2) *Other taxpayers.* In the case of a taxpayer, other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the net income of the taxpayer of [or] $1,000, whichever is smaller. For purposes of this paragraph, net income shall be computed without regard to gains or losses from sales or exchanges of capital assets. If the tax is to be computed under Supplement T, "net income" as used in this paragraph shall be read as "adjusted gross income"

[Sec. 117 (d) as amended by sec. 212 (a), Rev. Act 1939; sec. 150 (c), Rev. Act 1942; sec. 8 (d) (2), Individual Income Tax Act 1944]

§ 39.117 (d)-1 *Limitation on capital losses.* (a) Section 117 (d) (1) provides that, in the case of a corporation, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of the gains from such sales or exchanges, and section 117 (d) (2) provides that, in the case of a taxpayer other than a corporation, the losses from sales or exchanges of capital assets shall be allowed as a deduction only to the extent of the gains from such sales or exchanges, plus net income (computed without regard to such gains or losses) of the taxpayer or $1,000, whichever is smaller. Thus, where an individual taxpayer having an ordinary net income of $5,000, has a loss of $4,000 from the sale of a capital asset which he held for more than six months, such net long-term capital loss of $4,000 is allowable only to the extent of $1,000, the remaining $3,000 being a net capital loss. If the taxpayer's ordinary net income had been $400 instead of $5,000, only $400 of the net long-term capital loss of $4,000 would have been allowed, leaving a net capital loss

of $3,600. For carry-over of a net capital loss, see § 39.117 (e)-1.

(b) In the case of a bank, as defined in section 104, the limitation under section 117 (d) (1) is modified by section 117 (i) so that the excess of any losses of the taxable year from sales or exchanges of bonds, debentures, notes or certificates, or other evidences of an indebtedness issued by any corporation (including those issued by a government or political subdivision thereof) with interest coupons or in registered form, over gains of the taxable year from such sales or exchanges may be deductible in full as an ordinary loss.

(c) In case the tax is computed under Supplement T, the term "net income" shall be read as "adjusted gross income."

(d) In the case of a joint return made by a husband and wife, the limitation under section 117 (d) (2) relating to the allowance of losses from sales or exchanges of capital assets, is to be computed and the net capital loss determined with respect to the combined capital gains and losses of the spouses.

§ 39.117 (e) *Statutory provisions; capital gains and losses; capital loss carry-over*

Sec. 117. *Capital gains and losses.* * * *

(e) *Capital loss carry-over*—(1) *Method of computation.* If for any taxable year beginning after December 31, 1941, the taxpayer has a net capital loss, the amount thereof shall be a short-term capital loss in each of the five succeeding taxable years to the extent that such amount exceeds the total of any net capital gains of any taxable years intervening between the taxable year in which the net capital loss arose and such succeeding taxable year. For purposes of this paragraph a net capital gain shall be computed without regard to such net capital loss or to any net capital losses arising in any such intervening taxable years.

(2) *Rule for application of capital loss carry-over from 1941.* [Not applicable in 1952 and subsequent years.]

[Sec. 117 (e) as amended by sec. 212 (b), Rev. Act 1939; sec. 150 (c), Rev. Act 1942]

§ 39.117 (e)-1 *Net capital loss carry-over* (a) Any taxpayer sustaining a net capital loss may, under section 117 (e) (1) carry over such loss to each of the five succeeding taxable years and treat it in each of such five succeeding taxable years as a short-term capital loss to the extent not allowed as a deduction against any net capital gains of any taxable years intervening between the taxable year in which the net capital loss was sustained and the taxable year to which carried. The carry-over is thus applied in each succeeding taxable year to offset any net capital gain in such succeeding taxable year. The amount of the net capital loss carry-over may not be included in computing a new net capital loss of a taxable year which can be carried forward to the next five succeeding taxable years. In the case of nonresident alien individuals not engaged in trade or business within the United States, see section 211 and the regulations thereunder.

(b) The practical operation of the provisions of section 117 (e) (1) may be illustrated by the following example:

Example. (1) For the taxable years 1950 to 1954, inclusive, an individual is assumed to have a net short-term capital loss, net short-term capital gain, net long-term capital loss, net long-term capital gain, and net income as follows:

	1950	1951	1952	1953	1954
Carry-over from prior years:					
From 1950		($50,000)	($29,500)	($29,500)	
From 1952				(19,500)	($13,000)
Net short-term loss (computed without regard to the carry-overs)	($30,000)	(5,000)	(10,000)		
Net short-term gain (computed without regard to the carry-overs)				40,000	
Net long-term loss:					
50 percent taken into account	(20,500)				
100 percent taken into account			(10,000)	(5,000)	
Net long-term gain:					
50 percent taken into account		25,000			
100 percent taken into account					15,000
Ordinary net income (computed without regard to capital gains and losses)	500	500	500	1,000	500
Net capital gain (computed without regard to the carry-overs)		20,500		36,000	
Net capital loss	(50,000)		(19,500)		
Deduction allowable under sec. 23 (ee) and 117 (b)			None	None	1,000
Net income (computed with regard to deduction allowable under sec. 23 (ee) and 117 (b))			None	None	1,500

(2) *Net capital loss of 1950.* The net capital loss is $50,000. This figure, computed by taking into account 100 percent of short-term gains and losses and 50 percent of long-term gains and losses, is the excess of the losses from sales or exchanges of capital assets over the sum of (i) gains from such sales or such exchanges, and (ii) ordinary net income of $500. This amount may be carried forward in full as a short-term loss to 1951. However, in 1951 there was a net capital gain of $20,500, as defined by section 117 (a) (10) (B) and limited by section 117 (e) (1), against which this net capital loss of $50,000 is allowed in part. The remaining portion—$29,500—may be carried forward to 1952 and 1953 since there was no net capital gain in 1952. In 1953 this $29,500 is allowed in full against net capital gain of $36,000, as defined by section 117 (a) (10) (B) and limited by section 117 (e) (1). For 1952 and 1953 the net long-term capital loss is computed by taking into account 100 percent of gains and losses upon the sale or exchange of capital assets held for more than 6 months. However, in determining the amount of the capital loss carry-over ($29,500) to 1952 and 1953, the net capital loss for 1950 is computed by taking into account only 50 percent of gains and losses upon the sale or exchange of capital assets held for more than 6 months, and the net capital gain for 1951 is similarly computed.

(3) *Net capital loss of 1952.* The net capital loss is $19,500. This figure, computed by taking into account 100 percent of both long-term and short-term gains and losses, is the excess of the losses from sales or exchanges of capital assets over the sum of (i) gains from such sales or exchanges and (ii) ordinary net income of $500. This amount may be carried forward in full as a short-term loss to 1953. However, in 1953 there was a net capital gain of $6,500, as defined by section 117 (a) (10) (B) and limited by section 117 (e) (1), against which this net capital loss of $19,500 is allowed in part. The remaining portion—$13,000—may be carried forward to 1954. Since this amount is treated as a short-term capital loss in 1954 under section 117 (e) (1), the excess of the net long-term capital gain over the net short-term capital loss is $2,000. Half of this excess is allowable as a deduction under sections 23 (ee) and 117 (b). Thus, the taxpayer has a net income of $1,500 for 1954.

(c) If a husband and wife making a joint return for any taxable year did not make a joint return for the preceding taxable years (not exceeding five taxable years) the individual net capital loss of each spouse for each of such preceding taxable years shall be a short-term capital loss for the taxable year to the extent provided by section 117 (e) (1) If, however, a joint return was made for each of the preceding taxable years (not exceeding five taxable years), a net capital loss as shown by each joint return shall be a short-term capital loss for the taxable year to the extent provided by section 117 (e) (1) If a husband and wife making separate returns for any taxable year made a joint return for each of the preceding taxable years (not exceeding five taxable years), a net capital loss as shown by each such joint return shall be allocated to the spouses on the basis of their individual net capital losses for each of such preceding taxable years, and the net capital loss allocated to each spouse shall be a short-term capital loss of such spouse for the taxable year, to the extent provided in section 117 (e) (1)

§ 39.117 (f)-(g) *Statutory provisions; capital gains and losses; retirement of bonds, etc., gains and losses from short sales, etc.*

Sec. 117. *Capital gains and losses.* * * *

(f) *Retirement of bonds, etc.* For the purposes of this chapter, 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.

Sec. 22. [Second Liberty Bond Act] * * *

(d) * * * For purposes of taxation any increment in value represented by the difference between the price paid and the redemption value received (whether at or before maturity) for savings bonds and savings certificates shall be considered as interest. * * *

[Sec. 22 as added by Sec. 6, Pub. Law 3 (74th Cong.), and amended by Sec. 3, Pub. Debt Act 1941.]

(g) *Gains and losses from short sales, etc.* For the purpose of this chapter—

(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; and

(3) Gain from the sale or exchange of property, to the extent that the adjusted basis of such property is less than its adjusted basis determined without regard to section 124A (relating to amortization deduction), shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in subsection (j).

[Sec. 117 (g) as amended by sec. 216 (c), Rev. Act 1950]

§ 39.117 (g)-1 *Gains and losses from short sales; in general.* (a) For income tax purposes, a short sale is not deemed to be consummated until delivery of property to cover the short sale, and whether the recognized gain or loss from a short sale is long-term or short-term capital gain or loss shall be determined 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 six months, the recognized gain or loss would be considered short-term capital gain or loss, even though he had on hand other shares of the same stock which he held for more than six months. 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.

(b) As to certain short sales of capital assets to which section 117 (l) applies, see § 39.117 (l)-1.

§ 39.117 (g)-2 *Gain attributable to amortization deduction.* (a) Section 117 (g) (3) provides that gain from a sale or exchange of property, to the extent that the adjusted basis of such property is less than its adjusted basis determined without regard to section 124A, relating to amortization of emergency facilities, shall be considered as ordinary income. For example, on December 31, 1952, a taxpayer making his income tax returns on the calendar year basis acquires at a cost of $10,000 an emergency facility (used in his business) which normally would have a useful life of 20 years. Under section 124A he elects to begin the 60-month amortization period on January 1, 1953. He takes amortization deductions in the amount of $4,000 for the years 1953 and 1954 (24 months) On December 31, 1954, he sells the facility for $9,500. The adjusted basis of the facility on that date is $6,000 ($10,000 cost less $4,000 amortization) Without regard to section 124A, the facility would have been depreciated at the rate of $500 a year and its adjusted basis on December 31, 1954, would have been $9,000 ($10,000 cost less $1,000 depreciation) The difference between the facility's actual adjusted basis ($6,000) and its adjusted basis determined without regard to section 124A ($9,000) is $3,000. Accordingly, $3,000 of the $3,500 gain on the sale of the facility ($9,500 sale price less $6,000 adjusted basis) would be treated as ordinary income and the remaining $500 would be subject to the provisions of section 117 (j)

(b) If the taxpayer acquires other property in an exchange for an emergency facility with respect to which amortization deductions have been allowed, and if the basis in his hands of such other property is determined by reference to the basis of the emergency facility, then the basis of such other property is determined with regard to section 124A, and therefore the provisions of section 117 (g) (3) apply with respect to gain realized on a sale or exchange of such other property. The provisions of section 117 (g) (3) likewise apply with respect to gain realized on the sale or exchange of an emergency facility (or other property acquired, as described in the preceding sentence, in an exchange for an emergency facility) by a taxpayer in whose hands the basis of such facility (or other property) is determined by reference to the basis thereof in the hands of another person who was allowed deductions with respect to such facility under section 124A.

§ 39.117 (h) *Statutory provisions; capital gains and losses; holding period of property.*

SEC. 117. *Capital gains and 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. For the purposes of this paragraph, an involuntary conversion described in section 112 (f) shall be considered an exchange of the property converted for the property acquired.

(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, 45 Stat. 818, or the Revenue Act of 1932, 48 Stat. 705, or under the provisions of section 371 (c) of the Revenue Act of 1938 or this chapter, there shall be included the period for which he held the stock or securities in the distributing corporation prior to 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 chapter or section 118 of the Revenue Act of 1928, 45 Stat. 826, or the Revenue Act of 1932, 47 Stat. 208, or the Revenue Act of 1934, 48 Stat. 715, or the Revenue Act of 1936, 49 Stat. 1692, or the Revenue Act of 1938, 52 Stat. 503, 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.

(5) In determining the period for which the taxpayer has held stock or rights to acquire stock received upon a distribution, if the basis of such stock or rights is determined under section 113 (a) (19) (A), there shall (under regulations prescribed by the Commissioner with the approval of the Secretary) be included the period for which he held the stock in the distributing corporation prior to the receipt of such stock or rights upon such distribution.

(6) In determining the period for which the taxpayer has held stock or securities acquired from a corporation by the exercise of rights to acquire such stock or securities, there shall be included only the period beginning with the date upon which the right to acquire was exercised.

(7) In determining the period for which the taxpayer has held a residence, the acquisition of which resulted under section 112 (n) in the nonrecognition of any part of the gain realized on the sale, exchange, or involuntary conversion of another residence, there shall be included the period for which such other residence had been held as of the date of such sale, exchange, or involuntary conversion.

[Sec. 117 (h) as amended by sec. 214 (c), Rev. Act 1939; secs. 151 (c) (1) and 152, Rev. Act 1942; sec. 318 (b) (4), Rev. Act 1951]

§ 39.117 (h)-1 *Determination of period for which capital assets are held.* (a) 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 of the Internal Revenue Code or under section 118 of the 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. If property acquired as the result of a compulsory or involuntary conversion of other property of the taxpayer has under section 113 (a) (9) the same basis in whole or in part in the

hands of the taxpayer as the property so converted, the period for which the property so converted was held by the taxpayer must be included in the period for which the property acquired was held by the taxpayer.

(b) The period for which the taxpayer has held stock, or stock subscription rights, issued to him as a dividend shall be determined as though the stock dividend, or stock right, as the case may be, were the stock in respect of which the dividend was issued if the basis for determining gain or loss upon the sale or other disposition of such stock dividend or stock right is fixed by the apportionment of the basis of such old stock.

(c) The period for which the taxpayer has held stock or securities issued to him by a corporation pursuant to the exercise by him of rights to acquire such stock or securities from the corporation will, in every case and whether or not the receipt of taxable gain was recognized in connection with the distribution of the rights, begin with and include the day upon which the rights to acquire such stock or securities were exercised. A taxpayer will be deemed to have exercised rights received from a corporation to acquire stock or securities therein where there is an expression of assent to the terms of such rights made by the taxpayer in the manner requested or authorized by the corporation.

(d) The period for which the taxpayer has held a residence, the acquisition of which resulted, under the provisions of section 112 (n) in the nonrecognition of any part of the gain realized on the sale, exchange, or involuntary conversion of another residence, shall include the period for which such other residence had been held as of the date of such sale, exchange, or involuntary conversion. See § 39.112 (n)-1.

§ 39.117 (i)-(j) *Statutory provisions; capital gains and losses; bond, etc., losses of banks; gains and losses from involuntary conversions and from sales or exchanges of certain property used in the trade or business.*

SEC. 117. *Capital gains and losses.* * * * (i) *Bond, etc., losses of banks.* For the purposes of this chapter, in the case of a bank, as defined in section 104, if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, 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, exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset.

[Sec. 117 (i) as amended by sec. 150 (d), Rev. Act 1942]

(j) *Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business*—(1) *Definition of property used in the trade or business.* For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a) (1) (C). Such term also includes timber or coal with respect to which subsection (k) (1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(2) *General rule.* If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of 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) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsection (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

(3) *Sale of land with unharvested crop.* In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted as described in paragraph (2)) at the same time and to the same person, the crop shall be considered as "property used in the trade or business."

[Sec. 117 (j) as added by sec. 151 (b), Rev. Act 1942; amended by sec. 127, Rev. Act 1943; sec. 210 (b), Rev. Act 1950; secs. 322 (c) (3), 323 (a), 324, 325 (a), Rev. Act 1951]

§ 39.117 (j)-1 *Gains and losses from involuntary conversions and from the sale or exchange of certain property used in the trade or business.* (a) (1) The recognized gains and losses described in subdivisions (i) through (iv) of this subparagraph shall be treated as gains and losses from the sale or exchange of capital assets held for more than six months if the aggregate of such gains exceeds the aggregate of such losses. If the aggregate of such gains does not exceed the aggregate of such losses, such gains and losses shall not be treated as gains and losses from the sale or exchange of capital assets. The gains and losses referred to in this subparagraph are the following:

(i) Gains and losses from the sale, exchange, or involuntary conversion of "section 117 (j) property", as defined in subparagraph (3) of this paragraph, held for more than six months.

(ii) Gains and losses from the involuntary conversion of capital assets held for more than six months.

(iii) Gains and losses upon the cutting or disposal of timber, or disposal of coal, to the extent provided in § 39.117 (k)-1.

(iv) Gains and losses from the sale, exchange, or involuntary conversion of livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for twelve months or more from the date of acquisition. See § 39.117 (j)-2.

(v) Gains and losses from the sale, exchange, or involuntary conversion of an unharvested crop under the conditions specified in paragraph (d) of this section.

(2) For the purpose of this section, the "involuntary conversion" of property is the conversion of such property into money or other property as a result of 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. Losses upon the destruction in whole or in part, theft or seizure, requisition or condemnation of property are treated as losses upon an involuntary conversion whether or not there was a conversion of the property into money or other property. For example, if a capital asset held for more than six months, with an adjusted basis of $400, is stolen, and the loss from this theft is not compensated for by insurance or otherwise, the $400 loss is included in the computations under section 117 (j)

(3) For the purpose of this section, the term "section 117 (j) property" means property used in the trade or business of the taxpayer at the time of its sale, exchange, or involuntary conversion, which is of a character subject to the allowance for depreciation provided in section 23 (l) or which is real property, except any such property which is within one of the following categories:

(i) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or which is held by the taxpayer primarily for sale to customers in the ordinary course of trade or business.

(ii) A copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in section 117 (a) (1) (C)

(iii) Livestock held for draft, breeding, or dairy purposes. See, however, subparagraph (1) (iv) of this paragraph.

(iv) Poultry.

(b) In determining whether the gains described in paragraph (a) (1) of this section exceed the losses described therein, such gains and losses are taken into

account in full, that is, 100 percent of such gains and losses is taken into account. The provisions of section 117 (d) limiting the deduction of capital losses are not applicable to exclude any losses from the computations under section 117 (j) With these exceptions, gains are included in the computations under section 117 (j) only to the extent that they are taken into account in computing gross income, and losses are included only to the extent that they are taken into account in computing net income. Thus, losses which are not deductible items under section 24 or section 118 are not included in the computations under section 117 (j) Similarly, if a taxpayer reports on the installment basis under section 44 the gain on the sale of property described in section 117 (j) only the portion of the gain reported under section 44 is included in the computation for such taxable year under section 117 (j). Any gains and losses which are not recognized under section 112 are not included in the computations under section 117 (j) Thus, if property is involuntarily converted into similar property, so that the gain on such conversion is not recognized under the provisions of section 112 (f) such gain is not included in the computations under section 117 (j)

(c) If it is determined under the above computations that the gains exceed the losses, all of such gains and losses are treated as gains and losses from the sale or exchange of capital assets held for more than six months. All such gains and losses are then subject to the limitations of section 117 (c) and (d) relating to the alternative tax in the case of capital gains and losses and to the extent to which capital losses are allowed. If it is determined under the above computations that the gains do not exceed the losses, none of such gains and losses are treated as gains and losses from the sale or exchange of capital assets, and such losses are then not subject to the limitations provided in section 117 (d)

(d) The conditions referred to in paragraph (a) (1) (v) of the section are: (1) The unharvested crop is on land which is "section 117 (j) property" as defined in paragraph (a) (3) of this section, and such land has been held for more than six months; (2) such crop and such land are sold, exchanged, or converted at the same time and to the same person; and (3) no right or option (other than one customarily incident to a mortgage or other security transaction) is retained by the taxpayer, at the time of the sale, exchange, or conversion, to reacquire, directly or indirectly, the land. The length of time for which the crop, as distinguished from the land, has been held is immaterial. A leasehold or estate for years is not "land" for the purpose of this section.

(e) The following examples will illustrate the operation of the provisions of section 117 (j)

Example (1). A, an individual, makes his income tax return on the calendar year basis. A's recognized gains and losses for 1952 of the kind described in section 117 (j) are as follows:

	Gains	*Losses*
1. Gain on sale of machinery, used in the business and subject to an allowance for depreciation, held for more than 6 months	$4,000	
2. Gain reported in 1952 (under sec. 44) on installment sale in 1951 of factory premises used in the business (including building and land, each held for more than 6 months)	6,000	
3. Gain reported in 1952 (under sec. 44) on installment sale in 1952 of land held for more than 6 months, used in the business as a storage lot for trucks	2,000	
4. Gain on proceeds from requisition by Government of boat, held for more than 6 months, used in the business and subject to an allowance for depreciation	500	
5. Loss upon the destruction by fire of warehouse, held for more than 6 months and used in the business (excess of adjusted basis of warehouse over compensation by insurance, etc.)		$3,000
6. Loss upon theft of unregistered bearer bonds, held for more than 6 months		5,000
7. Loss in storm of pleasure yacht, purchased in 1950 for $1,800 and having a fair market value of $1,000 at the time of the storm		1,000
8. Total gains	12,500	
9. Total losses		9,000
10. Excess of gains over losses	3,500	

Since the aggregate of the respective recognized gains ($12,500) exceeds the aggregate of such losses ($9,000), such gains and losses are treated under section 117 (j) as gains and losses from the sale or exchange of capital assets held for more than six months.

Example (2). If in example (1) A also had a loss of $4,000 from the sale under threat of condemnation of a capital asset held for more than six months, then the gains ($12,500) would not exceed the losses ($9,000 plus $4,000, or $13,000). Neither the loss on such sale of a capital asset nor any of the other items set forth in example (1) would then be treated as gains and losses from the sale or exchange of capital assets, but all of such items would be treated as ordinary gains and losses.

Example (3). A's yacht, used for pleasure and acquired for such use in 1945 at a cost of $25,000, was requisitioned by the Government in 1952 for $15,000. A sustained no deductible loss, and no loss with respect to such requisition will be included in the computations under section 117 (j).

§ 39.117 (j)-2 *Livestock held for draft, breeding, or dairy purposes.* (a) For the purpose of section 117 (j), the term "livestock" shall be given a broad, rather than a narrow, interpretation and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. It does not include chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc.

(b) The determination whether or not livestock is held by the taxpayer for a draft, breeding, or dairy purpose depends upon all of the facts and circumstances in each particular case. The purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal. However, a draft, breeding, or dairy purpose may be present in a case where the animal is disposed of within a reasonable time after its intended use for such purpose is prevented by accident, disease, or other circumstance. An animal held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business may, depending upon the circumstances, be considered held for a draft, breeding, or dairy purpose. An animal is not held by the taxpayer for a draft, breeding, or dairy purpose merely because it is suitable for such purpose or because it is held by the taxpayer for sale to other persons for use by them for such purpose. Furthermore, an animal held by the taxpayer for other purposes is not considered to be held for a draft, breeding, or dairy purpose merely because of a negligible use of the animal for such purpose or because of the use of the animal for such purpose as an ordinary or necessary incident to the purpose for which the animal is held.

(c) These principles may be illustrated by the following examples:

Example (1). An animal intended by the taxpayer for use by him for breeding purposes is discovered to be sterile, and is disposed of within a reasonable time thereafter. This animal was held for breeding purposes.

Example (2). The taxpayer retires from the breeding or dairy business and sells his entire herd, including young animals which would have been used by him for breeding or dairy purposes if he had remained in business. These young animals were held for breeding or dairy purposes.

Example (3). A taxpayer in the business of raising hogs for slaughter customarily breeds sows to obtain a single litter to be raised by him for sale, and sells these brood sows after obtaining the litter. Even though these brood sows are held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business, they are considered to be held for breeding purposes.

Example (4). A taxpayer in the business of raising horses for sale to others for use by them as draft horses uses such horses for draft purposes on his own farm in order to train them. This use is an ordinary or necessary incident to the purpose of selling such animals, and, accordingly, these horses are not held for draft purposes.

Example (5). The taxpayer is in the business of raising registered cattle for sale to others for use by them as breeding cattle. It is the business practice for the cattle to be bred, prior to sale, in order to establish their fitness for sale as registered breeding cattle. In such case, those cattle used by the taxpayer to produce calves which calves are added to the taxpayer's herd (whether or not the breeding herd) are considered to be held for breeding purposes; the breeding of other cattle is an ordinary or necessary incident to the holding of such other cattle for the purpose of selling them as registered breeding cattle, and the breeding of such cattle does not demonstrate that the taxpayer is holding the cattle for breeding purposes.

Example (6). A taxpayer, engaged in the business of buying cattle and fattening them

for slaughter, purchased cows with calf. The calves were born while the cows were held by the taxpayer. These cows were not held for breeding purposes.

§ 39.117 (k) *Statutory provisions; capital gains and losses; gain or loss in the case of timber or coal.*

SEC. 117. *Capital gains and losses.* * * *
(k) *Gain or loss in the case of timber or coal.* (1) If the taxpayer so elects upon his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than six months prior to the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. In case such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the adjusted basis for depletion of such timber in the hands of the taxpayer and the fair market value of such timber. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this paragraph such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding upon the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Commissioner, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this paragraph except with the consent of the Commissioner.

(2) In the case of the disposal of timber or coal (including lignite), held for more than 6 months prior to such disposal, by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber or coal, the difference between the amount received for such timber or coal and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber or coal. Such owner shall not be entitled to the allowance for percentage depletion provided for in section 114 (b) (4) with respect to such coal. This paragraph shall not apply to income realized by the owner as a co-adventurer, partner, or principal in the mining of such coal. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income, or the net income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this paragraph. This paragraph shall have no application, in the case of coal, for the purposes of applying section 102 or subchapter A of chapter 2 (including the computation under section 117 (c) (1) of a tax in lieu of the tax imposed by section 500).

[Sec. 117 (k) as added by sec. 127 (a), Rev. Act 1943, amended by sec. 325 (b) (c), Rev. Act 1951]

§ 39.117 (k)-1 *Gain or loss upon the cutting and disposal of timber and the disposal of coal*—(a) *Gain or loss upon the cutting of timber*—(1) *Election to consider cutting as a sale or exchange.* (i) A taxpayer who has owned, or has held a contract right to cut, timber for a period of more than six months before the beginning of the taxable year may elect under section 117 (k) (1) to consider the cutting of such timber during such year for sale or for use in the taxpayer's trade or business as a sale or exchange of the timber so cut. Such election must be made by the taxpayer in its income tax return for the taxable year, and cannot be made thereafter. The election shall take the form of a computation in the return under the provisions of section 117 (k) (1) and section 117 (j)

(ii) The election made under the provisions of section 117 (k) (1) shall be applicable with respect to all timber which was owned by the taxpayer or which the taxpayer had a contract right to cut, and the cutting of timber, whether or not actually sold or exchanged, shall be considered to be a sale or exchange, except that timber which is not cut for sale or for use in the taxpayer's trade or business and timber which was held for a period of not more than six months before the beginning of the taxable year shall not be considered to have been sold or exchanged upon the cutting thereof. The election provided by section 117 (k) (1) may be made with respect to any taxable year even though such election was not made with respect to any previous taxable year. If an election has been made under the provisions of section 117 (k) (1) however, such election shall be binding upon the taxpayer not only for the taxable year for which the election is made but also for all subsequent taxable years, unless the Commissioner on showing by the taxpayer of undue hardship permits the taxpayer to revoke his election for such subsequent taxable years. Such election shall apply with respect to all timber which the taxpayer has owned, or has had a contract right to cut, for a period of more than six months before the beginning of a subsequent taxable year and which was cut for sale or for use in the taxpayer's trade or business, whether such timber or contract right was acquired prior or subsequent to the election. If the taxpayer has revoked his election, such revocation shall preclude any further elections by the taxpayer under section 117 (k) (1) except with the consent of the Commissioner.

(2) *Computation of gain or loss.* (i) If the cutting of timber is considered as a sale or exchange pursuant to an election made under the provisions of section 117 (k) (1) gain or loss shall be recognized to the taxpayer in an amount equal to the difference between the adjusted basis for depletion in the hands of the taxpayer of the timber which has been cut during the taxable year and the fair market value of such timber as of the first day of the taxable year in which such timber is cut. The adjusted basis for depletion of such cut timber shall be based upon the number of units of timber cut during the taxable year which are considered to be sold or exchanged and upon the depletion unit of the timber in the timber account or accounts pertaining to the timber cut, and shall be computed in the same manner as is provided in § 39.23 (m)-21 with respect to the computation of the allowance for depletion.

(ii) The fair market value of the timber as of the first day of the taxable year in which such timber is cut shall be determined, subject to approval or revision by the Commissioner upon examination of the taxpayer's return, by the taxpayer electing to apply the provisions of section 117 (k) (1) 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 that particular day. Due consideration will be given to the factors and the principles involved in the determination of the fair market value of timber as described in § 39.23 (m)-25.

(iii) The fair market value as of the beginning of the taxable year of the timber cut during such year shall be considered to be the cost of the timber which was cut, in lieu of the actual cost or other basis of such timber, for all purposes for which such cost is a necessary factor. Thus, if the products of the timber cut during a taxable year were sold during such year, the fair market value as of the beginning of such taxable year of the timber cut during the year shall be used in computing the depletion unit and the allowance for depletion as provided in § 39.23 (m)-21. This is also the rule in case the products of the timber cut during one taxable year with respect to which an election has been made under section 117 (k) (1) are sold during a subsequent taxable year, whether or not the election provided in section 117 (k) (1) is applicable with respect to such subsequent year. If the products of the timber cut during a taxable year with respect to which an election under section 117 (k) (1) was made were not sold during such year and are included in inventory at the close of such year, the fair market value as of the beginning of the year of the timber cut during the year shall be used in lieu of the actual cost of such timber in computing the closing inventory for such year and the opening inventory for the succeeding year. With respect to the costs applicable in the determination of the amount of such inventories, there shall be included the fair market value of the timber cut, the costs of cutting, logging, and all other expenses incident to the cost of converting the standing timber into the products in inventory. See § 39.22(c)-3. The fact that the fair market value as of the first day of the taxable year in which the timber is cut is deemed to be the cost of such timber shall not preclude the taxpayer from computing its inventories upon the basis of cost or market, whichever is lower, if such is the method used by the taxpayer. Nor shall it preclude the taxpayer from computing its inventories under the last-in first-out inventory method provided by section 22 (d) if such section is ap-

plicable to, and has been elected by, the taxpayer.

(iv) For any taxable year for which the cutting of timber is considered to be a sale or exchange of such timber under section 117 (k) (1) the timber so cut shall be considered as property used in the trade or business for the purposes of section 117 (j) along with other property of the taxpayer used in the trade or business as defined in section 117 (j) (1) Whether the gain or loss considered to have resulted from the cutting of the timber will be considered to be gain or loss resulting from the sale or exchange of capital assets held for more than six months depends upon the application of section 117 (j) to the taxpayer for the taxable year. See § 39.117 (j)-1.

(v) In case the products of the timber are sold after cutting, either in the form of logs or lumber or in the form of a manufactured product, the income from such actual sale shall be considered ordinary income. In determining the cost of the products so sold, the cost of the timber shall be computed pursuant to the provisions of section 117 (k) (1)

(b) *Gain or loss upon the disposal of timber under cutting contract.* If a taxpayer disposes of timber under any form or type of contract whereby he retains an economic interest in such timber, the disposal under the contract shall be considered to be a sale of such timber. The difference between the amounts received for the timber in any taxable year and the adjusted basis for depletion of the timber with respect to which the amounts were so received shall be considered to be a gain or loss upon the sale of such timber for such year. If the taxpayer owned the timber for a period of more than six months before the date of such contract, for the purposes of section 117 (j) such timber shall be considered to be property used in the trade or business for the taxable year for which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 117 (j) (1) Whether gain or loss resulting from the disposition of the timber which is considered to have been sold will be deemed to be gain or loss resulting from the sale of a capital asset held for more than six months will depend upon the application of section 117 (j) in the case of the taxpayer.

(c) *Gain or loss upon the disposal of coal.* (1) If a taxpayer disposes of coal (including lignite) held for more than six months prior to such disposal, under any form or type of contract whereby he retains an economic interest in such coal, the difference between the amount received for such coal and the adjusted depletion basis thereof under section 114 (b) (1) shall be considered to be a gain or loss upon the sale of such coal.

(2) The adjusted depletion basis under section 114 (b) (1) for the purpose of this section, includes adjustments for development and exploration expenditures and for deductions under section 113 (b) (1) (J) and (M) For the purpose of this section, the date of disposal of the coal shall be deemed to be the date the coal is mined. If the coal has been held for more than six months on the date that it is mined, it is immaterial that it had not been held for more than six months on the date of the contract. For the purpose of section 117 (j) such coal shall be considered to be property used in the trade or business, along with other property of the taxpayer used in the trade or business as defined in section 117 (j) (1) Whether gain or loss resulting from the disposition of the coal will be deemed to be gain or loss resulting from the sale of a capital asset held for more than six months will depend upon the application of section 117 (j) to that and other transactions of the taxpayer.

(3) There shall be no allowance for percentage depletion provided for in section 114 (b) (4) with respect to amounts received any part of which are considered to be received from the sale of coal under section 117 (k) (2) In computing the gross income, adjusted gross income, or the net income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of section 117 (k) (2) Section 117 (k) (2) shall have no application with respect to amounts received by a taxpayer as a co-adventurer, partner, or principal in the mining of coal.

(4) To the extent any advance payments are treated, under section 117 (k) (2) as received from the sale of coal for any taxable year, and the grant of the coal rights for which such payments are made expires, terminates, or is abandoned in a later taxable year before the coal which has been paid for has been mined, the grantor shall recompute the tax liability for the prior taxable year and treat such payments to such extent as not received from the sale of the coal; such recomputation should be in the form of an "amended return" if necessary.

§ 39.117 (l) *Statutory provisions; capital gains and losses; short sales, etc.*

SEC. 117. *Capital gains and losses.* * * *

(l) *Short sales, etc.* In the case of a short sale of property made by the taxpayer after the date of the enactment of the Revenue Act of 1950:

(1) *Short-term gains and holding periods.* If substantially identical property has been held by the taxpayer on the date of such short sale for not more than 6 months (determined without regard to the effect, under subparagraph (B) of this paragraph, of such short sale on the holding period), or if substantially identical property is acquired by the taxpayer after such short sale and on or before the date of the closing thereof—

(A) Any gain upon the closing of such short sale shall be considered as a gain upon the sale or exchange of a capital asset held for not more than 6 months (notwithstanding the period of time any property used to close such short sale has been held); and

(B) The holding period of such substantially identical property shall be considered to begin (notwithstanding the provisions of subsection (h)) on the date of the closing of the short sale, or on the date of a sale, gift, or other disposition of such property, whichever date occurs first. This subparagraph shall apply to such substantially identical property in the order of the dates of the acquisition of such property, but only to so much of such property as does not exceed the quantity sold short.

For the purposes of this paragraph, the acquisition of an option to sell property at a fixed price shall be considered as a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale.

(2) *Long-term losses.* If substantially identical property has been held by the taxpayer on the date of such short sale for more than 6 months, any loss upon the closing of such short sale shall be considered as a loss upon the sale or exchange of a capital asset held for more than 6 months (notwithstanding the period of time any property used to close such short sale has been held, and notwithstanding the provisions of subsection (g) (2)).

(3) *Rules for application of subsection.* (A) The provisions of paragraph (1) (A) or (2) shall not apply to the gain or loss, respectively, on any quantity of property used to close such short sale which is in excess of the quantity of the substantially identical property referred to in the applicable paragraph.

(B) For the purposes of this subsection—

(i) The term "property" includes only stocks and securities (including stocks and securities dealt with on a "when issued" basis), and commodity futures, which are capital assets in the hands of the taxpayer;

(ii) In the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in one calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month; and

(iii) In the case of a short sale of property by an individual, the term "taxpayer" in the application of this paragraph and paragraphs (1) and (2), shall be read as "taxpayer or his spouse"· but an individual who is legally separated from the taxpayer under a decree of divorce or of separate maintenance shall not be considered as the spouse of the taxpayer.

(C) Where the taxpayer enters into two commodity futures transactions on the same day, one requiring delivery by him in one market and the other requiring delivery to him of the same (or substantially identical) commodity in the same calendar month in a different market, and the taxpayer subsequently closes both such transactions on the same day, this subsection shall have no application to so much of the commodity involved in either such transaction as does not exceed in quantity the commodity involved in the other.

[Sec. 117 (l) as added by sec. 211 (a), Rev. Act 1950]

§ 39.117 (l)-1 *Gains and losses from certain short sales of capital assets*—(a) *General.* Section 117 (l) provides rules as to the tax consequences of certain short sales of property if, at the time of the short sale or on or before the date of the closing of the short sale, the taxpayer holds property substantially identical to that sold short. The term "property" is defined in section 117 (l) to include only stocks and securities (including stocks and securities dealt with on a "when issued" basis) and commodity futures, which are capital assets in the hands of the taxpayer. Certain restrictions on the application of the section to commodity futures are provided in section 117 (l) (3) and paragraph (c) (2) of this section.

(b) *Treatment of short sales.* (1) The first two rules, which are set forth in

section 117 (l) (1) are applicable whenever property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than 6 months (determined without regard to rule (2) below, relating to the holding period) or is acquired by him after the short sale and on or before the date of the closing thereof. These rules are

Rule (1). Any gain upon the closing of such short sale shall be considered as a gain upon the sale or exchange of a capital asset held for not more than 6 months (notwithstanding the period of time any property used to close such short sale has been held); and

Rule (2). The holding period of such substantially identical property shall be considered to begin (notwithstanding the provisions of section 117 (h)) on the date of the closing of such short sale or on the date of a sale, gift, or other disposition of such property, whichever date occurs first.

For the purpose of rule (1) and rule (2) the acquisition of an option to sell property at a fixed price shall be considered a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale.

(2) The third rule, which is set forth in section 117 (l) (2), is applicable whenever property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for more than 6 months. This rule is:

Rule (3). Any loss upon the closing of such short sale shall be considered as a loss upon the sale or exchange of a capital asset held for more than 6 months, nothwithstanding the period of time any property used to close such short sale has been held. For the purpose of rule (3), the acquisition of an option to sell property at a fixed price is not considered a short sale, and the exercise or failure to exercise such option is not considered as a closing of a short sale.

(3) Rules (1) and (3) do not apply to the gain or loss attributable to so much of the property sold short as exceeds in quantity the substantially identical property referred to in sections 117 (l) (1) and 117 (l) (2) respectively. Rule (2) applies to the substantially identical property referred to in section 117 (l) (1) in the order of the dates of the acquisition of such property but only to so much of such property as does not exceed the quantity sold short. If property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than 6 months, or is acquired by him after the short sale and on or before the date of the closing thereof, and if property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for more than 6 months, all three rules are applicable.

(4) The following examples illustrate the application of these rules to short sales of stock in the case of a taxpayer who makes his return on the basis of the calendar year:

Example (1). A buys 100 shares of X stock at $10 per share on February 1, 1952, sells short 100 shares of X stock at $16 per share on July 1, 1952, and closes the short sale on August 2, 1952, by delivering the 100 shares of X stock purchased on February 1, 1952, to the lender of the stock used to effect the short sale. Since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of $600 realized upon the closing of the short sale is, by application of rule (1), a short-term capital gain.

Example (2). A buys 100 shares of X stock at $10 per share on February 1, 1952, sells short 100 shares of X stock at $16 per share on July 1, 1952, closes the short sale on August 1, 1952, with 100 shares of X stock purchased on that date at $18 per share, and on August 2, 1952, sells at $18 per share the 100 shares of X stock purchased on February 1, 1952. The $200 loss sustained upon the closing of the short sale is a short-term capital loss to which section 117 (l) has no application. By application of rule (2), however, the holding period of the 100 shares of X stock purchased on February 1, 1952, and sold on August 2, 1952, is considered to begin on August 1, 1952, the date of the closing of the short sale. The $800 gain realized upon the sale of such stock is, therefore, a short-term capital gain.

Example (3). A buys 100 shares of X stock at $10 per share on February 1, 1952, sells short 100 shares of X stock at $16 per share on September 1, 1952, sells on October 1, 1952, at $18 per share the 100 shares of X stock purchased on February 1, 1952, and closes the short sale on October 1, 1952, with 100 shares of X stock purchased on that date at $18 per share. The $800 gain realized upon the sale of the 100 shares of X stock purchased on February 1, 1952, is a long-term capital gain to which section 117 (l) has no application. Since A had held 100 shares of X stock on the date of the short sale for more than 6 months, the $200 loss sustained upon the closing of the short sale is, by application of rule (3), a long-term capital loss.

Example (4). A sells short 100 shares of X stock at $16 per share on February 1, 1952. He buys 250 shares of X stock on March 1, 1952, at $10 per share and holds the latter stock until September 2, 1952 (more than 6 months), at which time, 100 of the 250 shares of X stock are delivered to close the short sale made on February 1, 1952. Since substantially identical property was acquired by A after the short sale and before it was closed, the $600 gain realized on the closing of the short sale is, by application of rule (1), a short-term capital gain. The holding period of the remaining 150 shares of X stock is not affected by section 117 (l) since this amount of the substantially identical property exceeds the quantity of the property sold short.

Example (5). A buys 100 shares of X stock at $10 per share on February 1, 1952, buys an additional 100 shares of X stock at $20 per share on July 1, 1952, sells short 100 shares of X stock at $30 per share on September 1, 1952, and closes the short sale on February 1, 1953, by delivering the 100 shares of X stock purchased on February 1, 1952, to the lender of the stock used to effect the short sale. Since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of $2,000 realized upon the closing of the short sale is, by application of rule (1), a short-term capital gain, and the holding period of the 100 shares of X stock purchased on July 1, 1952, is considered, by application of rule (2), to begin on February 1, 1953, the date of the closing of the short sale. If, however, the 100 shares of X stock purchased on July 1, 1952, had been used by A to close the short sale, then, since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of $1,000 realized upon the closing of the short sale would be, by application of rule (1), a short-term capital gain, but the holding period of the 100 shares of X stock purchased on February 1, 1952, would not be affected by section 117 (l). If, on the other hand, A purchased an additional 100 shares of X stock at $40 per share on February 1, 1953, and used such shares to close the short sale at that time, then, since 100 shares of X stock had been held by A on the date of the short sale for more than 6 months, the loss of $1,000 sustained upon the closing of the short sale would be, by application of rule (3), a long-term capital loss, and, since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the holding period of the 100 shares of X stock purchased on July 1, 1952, would be considered, by application of rule (2), to begin on February 1, 1953, but the holding period of the 100 shares of X stock purchased on February 1, 1952, would not be affected by section 117 (l).

Example (6). A buys 100 shares of X preferred stock at $10 per share on February 1, 1952. On July 1, 1952, he enters into a contract to sell 100 shares of XY common stock at $16 per share when, as, and if issued pursuant to a particular proposed plan of reorganization. On August 2, 1952, he receives 100 shares of XY common stock in exchange for the 100 shares of X preferred stock purchased on February 1, 1952, and delivers such common shares in performance of his July 1, 1952, contract. Assume that the exchange of the X preferred stock for the XY common stock is a tax-free exchange pursuant to section 112 (b) (3), and that on the basis of all of the facts and circumstances existing on July 1, 1952, the "when issued" XY common stock is substantially identical to the X preferred stock. Since 100 shares of substantially identical property had been held by A for not more than 6 months on the date of entering into the July 1, 1952, contract of sale, the gain of $600 realized upon the closing of the contract of sale is, by application of rule (1), a short-term capital gain.

(c) *Other rules for the application of section 117 (l)*—(1) *Substantially identical property*. The term "substantially identical property" is to be applied according to the facts and circumstances in each case. In general, as applied to stocks or securities, the term has the same meaning as the term "substantially identical stock or securities" used in section 118, relating to wash sales of stock or securities. For certain restrictions on the term as applied to commodity futures see sub-paragraph (2) of this paragraph. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. In certain situations they may be substantially identical; for example, in the case of a reorganization the facts and circumstances may be such that the stocks and securities of predecessor and successor corporations are substantially identical property. Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, in certain situations, as, for example, where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property. Similarly, depending on the facts and circumstances, the term may apply to the stocks and securities to be received in a corporate reorganization or recapitalization, traded in on a when issued

basis, as compared with the stocks or securities to be exchanged in such reorganization or recapitalization.

(2) *Commodity futures.* (i) As provided in section 117 (l) (3) (B) (ii) in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in one calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month. For example, commodity futures in May wheat and July wheat are not considered, for the purpose of section 117 (l) substantially identical property. Similarly, futures in different commodities which are not generally through custom of the trade used as hedges for each other (such as corn and wheat, for example) are not considered substantially identical property. If commodity futures are otherwise substantially identical property, the mere fact that they were procured through different brokers will not remove them from the scope of the term "substantially identical property" Commodity futures procured on different markets may come within the term "substantially identical property" depending upon the facts and circumstances in the case, with the historical similarity in the price movements in the two markets as the primary factor to be considered.

(ii) Since section 117 (l) applies only to sales or exchanges of capital assets, bona fide hedging transactions in commodity futures entered into by flour millers, producers of cloth, operators of grain elevators, etc., for the purpose of their business, and which do not give rise to capital gain or loss, are not within the scope of section 117 (l)

(iii) Section 117 (l) (3) (C) relating to so-called "arbitrage" transactions in commodity futures, provides that where a taxpayer enters into two commodity futures transactions on the same day, one requiring delivery by him in one market and the other requiring delivery to him of the same (or substantially identical) commodity in the same calendar month in a different market, and the taxpayer subsequently closes both such transactions on the same day, section 117 (l) shall have no application to so much of the commodity involved in either such transaction as does not exceed in quantity the commodity involved in the other.

(iv) The following example indicates the application of section 117 (l) to a commodity futures transaction:

Example. A, who makes his return on the basis of the calendar year, on February 1, 1952, enters into a contract through broker X to purchase 10,000 bushels of December wheat on the Chicago market at $2 per bushel. On July 1, 1952, he enters into a contract through broker Y to sell 10,000 bushels of December wheat on the Chicago market at $2.25 per bushel. On August 2, 1952, he closes both transactions at $2.50 per bushel. The $2,500 loss sustained on the closing of the short sale is a short-term capital loss to which section 117 (l) has no application. By application of rule (2) in paragraph (b) of this section, however, the holding period of the futures contract entered into on February 1, 1952, is considered to begin on August 2, 1952, the date of the closing of the short sale. The $5,000 gain realized upon the closing of such contract is, therefore, a short-term capital gain.

(3) *Husband and wife.* Section 117 (l) (3) (B) (iii) provides that, in the case of a short sale of property by an individual, the term "taxpayer" shall be read as "taxpayer or his spouse" Thus, if the spouse of a taxpayer holds or acquires property substantially identical to that sold short by the taxpayer, and the other conditions of this section are met, then the rules set forth herein are applicable to the same extent as if the taxpayer held or acquired the substantially identical property. For this purpose, an individual who is legally separated from the taxpayer under a decree of divorce or of separate maintenance shall not be considered as the spouse of the taxpayer.

§ 39.117 (m) *Statutory provisions; capital gains and losses; collapsible corporations.*

SEC. 117. *Capital gains and losses.* * * *

(m) *Collapsible corporations*—(1) *Treatment of gain to shareholders.* Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) *Definitions.* (A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in subsection (a) (1) (A), or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) The sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, and

(ii) The realization by such shareholders of gain attributable to such property.

(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, produced, or purchased property, if—

(i) It engaged in the manufacture, construction, or production of such property to any extent,

(ii) It holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or

(iii) It holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation.

(3) *Limitations on application of subsection.* In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

(A) This subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in subsection (a) (1) (A) or at any time thereafter, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

(B) This subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, produced, or purchased; and

(C) This subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, production, or purchase.

For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503 (a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants.

[Sec. 117 (m) as added by sec. 212 (a), Rev. Act 1950; amended by sec. 326 (a) (b), Rev. Act 1951]

§ 39.117 (m)-1 *Collapsible corporations*—(a) *In general.* Subject to the limitations contained in paragraph (c) of this section, the entire gain from (1) the actual sale or exchange of stock of a collapsible corporation, (2) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 115 (c) as payment in exchange for stock, and (3) a distribution made by a collapsible corporation which, under section 115 (d) is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as gain from the sale or exchange of property which is not a capital asset.

(b) *Determination of collapsible corporation.* (1) A collapsible corporation is defined by section 117 (m) (2) (A) to be a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in section 117 (a) (1) (A) or for the holding of stock in a corporation so formed or availed of, with a view to (i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise) or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, and (ii) the realization by such shareholders of gain attributable to such property.

(2) See paragraph (d) of this section for a description of the facts which will ordinarily be considered sufficient to establish whether or not a corporation is a collapsible corporation under the rules of this section. See paragraph (e) of this section for examples of the application of section 117 (m)

(3) Under section 117 (m) (2) (A) the corporation must be formed or

availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or a distribution to them, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property and the realization by the shareholders of gain attributable to such property. This requirement is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The requirement is satisfied whether such action was contemplated unconditionally, conditionally or as a recognized possibility. If the corporation was so formed or availed of, it is immaterial that a particular shareholder was not a shareholder at the time of the manufacture, construction, production, or purchase of the property, or if a shareholder at such time, did not share in such view, and any gain of such shareholder on his stock in the corporation shall be treated in the same manner as gain of a shareholder who did share in such view. See, however, the limitation contained in paragraph (c) (2) of this section. The existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of with a view to the action described in section 117 (m) (2) (A)

(4) A corporation is formed or availed of with a view to the action described in section 117 (m) (2) (A) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase) the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange, or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of.

(5) The property referred to in section 117 (m) (2) (A) is that property or the aggregate of those properties with respect to which the requisite view existed. In order to ascertain the property or properties as to which the requisite view existed, reference shall be made to each property as to which, at the time of the sale, exchange, or distribution referred to in section 117 (m) (2) (A) there has not been a realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property. However, where any such property is a unit of an integrated project involving several properties similar in kind, the determination whether the requisite view existed shall be made only if a substantial part of the net income to be derived from the project has not been realized at the time of the sale, exchange, or distribution, and in such case the determination shall be made by reference to the aggregate of the properties constituting the single project.

(6) A corporation shall be deemed to have manufactured, constructed, produced, or purchased property if it (i) engaged in the manufacture, construction, or production of property to any extent, or (ii) holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or (iii) holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation. Thus, under subdivision (i) of this subparagraph, for example, a corporation need not have originated nor have completed the manufacture, construction, or production of the property. Under subdivision (ii) of this subparagraph, for example, if an individual were to transfer property constructed by him to a corporation in exchange for all of the capital stock of such corporation, and such transfer qualifies under section 112 (b) (5) then the corporation would be deemed to have constructed the property, since the basis of the property in the hands of the corporation would, under section 113 (a) (8) be determined by reference to the basis of the property in the hands of the individual. Under subdivision (iii) of this subparagraph, for example, if a corporation were to exchange property constructed by it for property of like kind constructed by another person, and such exchange qualifies under section 112 (b) (1) then the corporation would be deemed to have constructed the property received by it in the exchange, since the basis of the property received by it in the exchange would, under section 113 (a) (6) be determined by reference to the basis of the property constructed by the corporation.

(7) In determining whether a corporation is a collapsible corporation by reason of the purchase of property, it is immaterial whether the property is purchased from the shareholders of the corporation or from persons other than such shareholders. The property, however, must be property which, in the hands of the corporation, is property of a kind described in section 117 (a) (1) (A) Section 117 (a) (1) (A) describes the following property: 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 its trade or business. The determination whether property is of a kind described in section 117 (a) (1) (A) shall be made without regard to the fact that the corporation is formed or availed of with a view to the action described in section 117 (m) (2) (A)

(8) Section 117 (m) is applicable whether the shareholder is an individual, a trust, an estate, a partnership, a company, or a corporation.

(c) *Limitations on application of section*—(1) *General.* This section shall apply only to the extent that the recognized gain of a shareholder upon his stock in a collapsible corporation would be considered, but for the provisions of this section, as gain from the sale or exchange of a capital asset held for more than six months. Thus, if a taxpayer sells at a gain stock of a collapsible corporation which he has held for six months or less, this section would not, in any event, apply to such gain. Also, if it is determined, under provisions of law other than section 117 (m), that a sale or exchange at a gain of stock of a collapsible corporation which has been held for more than six months results in ordinary income rather than long-term capital gain, then this section (including the limitations contained herein) has no application whatsoever to such gain.

(2) *Stock ownership rules.* (i) This section shall apply in the case of gain realized by a shareholder upon his stock in a collapsible corporation only if the shareholder, at any time after the actual commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in section 117 (a) (1) (A) or at any time thereafter, (*a*) owned, or was considered as owning, more than 10 percent in value of the outstanding stock of the corporation, or (*b*) owned stock which was considered as owned at such time by another shareholder who then owned, or was considered as owning, more than 10 percent in value of the outstanding stock of the corporation.

(ii) The ownership of stock shall be determined in accordance with the rules prescribed by section 503 (a) (1), (2), (3) (5) and (6), except that, in addition to the persons prescribed by section 503 (a) (2) the family of an individual shall include the spouses of that individual's brothers and sisters, whether such brothers and sisters are by the whole or the half blood, and the spouses of that individual's lineal descendants.

(iii) For the purpose of this limitation, treasury stock shall not be considered as outstanding stock.

(iv) It is possible, under this limitation, that a shareholder in a collapsible corporation may have gain upon his stock in that corporation treated differently from the gain of another shareholder in the same collapsible corporation.

(3) *Seventy-percent rule.* (i) This section shall apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 117 (m) (2) (A) If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such

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gain is so attributable, then none of such gain is subject to this section.

(ii) For the purpose of this limitation, the gain attributable to the property referred to in section 117 (m) (2) (A) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation or a distribution described in section 115 (d) the gain attributable to the property shall not be less than an amount which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

(iii) Gain may be attributable to the property referred to in section 117 (m) (2) (A) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half.

(4) *Three-year rule.* This section shall not apply to that portion of the gain of a shareholder that is realized more than three years after the actual completion of the manufacture, construction, production, or purchase of the property to which such portion is attributable.

(d) *Application of section.* (1) Whether or not a corporation is a collapsible corporation shall be determined under the rules of paragraph (b) of this section on the basis of all the facts and circumstances in each particular case. The following subparagraphs of this paragraph set forth those facts which will ordinarily be considered sufficient to establish that a corporation is or is not a collapsible corporation. The facts set forth in the following subparagraphs of this paragraph are not exclusive of other facts which may be controlling in any particular case. For example, if the facts in subparagraph (2) of this paragraph, but not the facts in subparagraph (3) of this paragraph, are present, the corporation may nevertheless not be a collapsible corporation if there are other facts which clearly establish that the rules of paragraph (b) of this section are not satisfied. Similarly, if the facts in subparagraph (3) of this paragraph are present, the corporation may nevertheless be a collapsible corporation if there are other facts which clearly establish that the corporation was formed or availed of in the manner described in paragraph (b) of this section, or if the facts in subparagraph (3) of this paragraph are not significant by reason of other facts, such as the fact that the corporation is subject to the control of persons other than those who were in control immediately prior to the manufacture, construction, production, or purchase of the property. See paragraph (c) of this section for provisions which make section 117 (m) inapplicable to certain shareholders of collapsible corporations.

(2) The following facts will ordinarily be considered sufficient (except as otherwise provided in subparagraph (1) of this paragraph and subparagraph (3) of this paragraph) to establish that a corporation is a collapsible corporation:

(i) A shareholder of the corporation sells or exchanges his stock, or receives a liquidating distribution, or a distribution described in section 115 (d)

(ii) Upon such sale, exchange, or distribution, such shareholder realizes gain attributable to the property described in subdivisions (iv) and (v) of this subparagraph, and

(iii) At the time of the manufacture, construction, production, or purchase of the property described in subdivisions (iv) and (v) of this subparagraph, such activity was substantial in relation to the other activities of the corporation which manufactured, constructed, produced, or purchased such property.

The property referred to in subdivisions (ii) and (iii) of this subparagraph is that property or the aggregate of those properties which meet the following two requirements:

(iv) The property is manufactured, constructed, or produced by the corporation or by another corporation stock of which is held by the corporation, or is property purchased by the corporation or by such other corporation which (in the hands of the corporation holding such property) is property described in section 117 (a) (1) (A) (relating to stock in trade, inventories, and property held primarily for sale to customers) and

(v) At the time of the sale, exchange, or distribution described in subdivision (i) of this subparagraph, the corporation which manufactured, constructed, produced, or purchased such property has not realized a substantial part of the net income to be derived from such property.

In the case of property which is a unit of an integrated project involving several properties similar in kind, the rules of this subparagraph shall be applied to the aggregate of the properties constituting the single project rather than separately to such unit. Under the rules of this subparagraph, a corporation shall be considered a collapsible corporation by reason of holding stock in other corporations which manufactured, constructed, produced, or purchased the property only if the activity of the corporation in holding stock in such other corporations is substantial in relation to the other activities of the corporation.

(3) The absence of any of the facts set forth in subparagraph (2) of this paragraph or the presence of the following facts will ordinarily be considered sufficient (except as otherwise provided in subparagraph (1) of this paragraph) to establish that a corporation is not a collapsible corporation:

(i) In the case of a corporation subject to the rules of subparagraph (2) of this paragraph only by reason of the manufacture, construction, production, or purchase (either by the corporation or by another corporation the stock of which is held by the corporation) of property which is property described in section 117 (a) (1) (A), the amount (both in quantity and value) of such property is not in excess of the amount which is normal—

(*a*) For the purpose of the business activities of the corporation which manufactured, constructed, produced, or purchased the property if such corporation has a substantial prior business history involving the use of such property and continues in business, or

(*b*) For the purpose of an orderly liquidation of the business if the corporation which manufactured, constructed, produced, or purchased such property has a substantial prior business history involving the use of such property and is in the process of liquidation.

(ii) In the case of a corporation subject to the rules of subparagraph (2) of this paragraph with respect to the manufacture, construction, or production (either by the corporation or by another corporation the stock of which is held by the corporation) of property, the amount of the unrealized net income from such property is not substantial in relation to the amount of the net income realized (after the completion of a material part of such manufacture, construction, or production, and prior to the sale, exchange, or distribution referred to in subparagraph (2) (i) of this paragraph) from such property and from other property manufactured, constructed, or produced by the corporation.

(e) *Examples.* The following examples will illustrate the application of this section:

Example (1). (i) On January 2, 1952, A formed the W corporation and contributed $50,000 cash in exchange for all of the stock thereof. The W corporation borrowed $900,000 from a bank, the loan being guaranteed by the Federal Housing Authority, and used $800,000 of such sum in the construction of an apartment house on land which it purchased for $50,000. The apartment house was completed on December 31, 1952. On December 31, 1952, the corporation, having determined that the fair market value of the apartment house, separate and apart from the land, was $900,000, made a distribution (permitted under the applicable State law) to A of $100,000. At this time, the fair market value of the land was $50,000. As of December 31, 1952, the corporation has not realized any earnings and profits. In 1953, the corporation began the operation of the apartment house and received rentals therefrom. The corporation has since continued to own and operate the building. The corporation reported on the basis of the calendar year and cash receipts and disbursements.

(ii) Since A received a distribution and realized a gain attributable to the building constructed by the corporation, since, at the time of such distribution, the corporation has not realized a substantial part of the net income to be derived from such building, and since the construction of the building was a substantial activity of the corporation, the W corporation is considered a collapsible corporation under paragraph (d) (2) of this

section. The provisions of section 117 (m) (3) do not prohibit the application of section 117 (m) (1) to A. Therefore, the distribution, if and to the extent that it may be considered long-term capital gain rather than ordinary income without regard to section 117 (m), will be considered ordinary income under section 117 (m) (1).

(iii) In the event of the existence of additional facts and circumstances in the above case, the corporation, notwithstanding the above facts, might not be considered a collapsible corporation. See paragraphs (b) and (d) (1) of this section.

Example (2). On January 2, 1952, B formed the X corporation and became the sole shareholder thereof. This corporation completed the construction of an office building in 1952. Immediately after the completion of the building, the corporation sold this building at a gain of $50,000, included this entire gain in its return for 1952, and distributed this entire gain (less taxes) to B. The corporation completed the construction of a second office building in June 1953. In August 1953, B sold the entire stock of the X corporation at a gain of $12,000, which gain is attributable to the second building. In view of the fact that B sold stock of the X corporation and realized a gain attributable to the second office building, that, at the time of such sale, the corporation had not realized a substantial part of the net income to be derived from such building, and that the construction of such building during the time of such construction was a substantial activity of the corporation, the X corporation is considered a collapsible corporation under paragraph (d) (2) of this section. Since the provisions of section 117 (m) (3) do not prohibit the application of section 117 (m) (1) to B, the gain of $12,000 to B is, accordingly, considered ordinary income.

Example (3). The facts in this example are the same as in example (2), except that the following facts are shown: B was the president of the X corporation and active in the conduct of its business. The second building was constructed as the first step in a project of the X corporation for the development for rental purposes of a large suburban center involving the construction of several buildings by the corporation. The sale of the stock by B was caused by his retiring from all business activity as a result of illness arising after the second building was constructed. Under these additional facts, the corporation is not considered a collapsible corporation. See paragraphs (b) and (d) (1) of this section.

Example (4). (i) On January 2, 1948, C formed the Y corporation and became the sole shareholder thereof. The Y corporation has been engaged solely in the business of producing motion pictures and licensing their exhibition. On January 2, 1953, C sold all of the stock of the Y corporation at a gain. The Y corporation has produced one motion picture each year since its organization and before January 2, 1953, it has realized a substantial part of the net income to be derived from each of its motion pictures except the last one made in 1952. This last motion picture was completed September 1, 1952. As of January 2, 1953, no license had been made for its exhibition. The fair market value on January 2, 1953, of this last motion picture exceeds the cost of its production by $50,000. A material part of the production of this last picture was completed on January 1, 1952, and between that date and January 2, 1953, the corporation had realized net income of $500,000 from other motion pictures produced by it. The corporation has consistently distributed to its shareholder its net income when received (after adjustment for taxes).

(ii) Although the corporation is within paragraph (d) (2) of this section with respect to the production of property, the amount of the unrealized net income from such property ($50,000) is not substantial in relation to the amount of the net income realized, after the completion of a material part of the production of such property and prior to sale of the stock, from such property and other property produced by the corporation ($500,000). Accordingly, the Y corporation is within paragraph (d) (3) (ii) of this section, and is not considered a collapsible corporation.

Example (5). The facts are the same as in example (4) except that C sold all of his stock to D on February 1, 1952. On January 2, 1953, D sold all of the Y corporation stock at a gain, the gain being attributable to the picture completed September 1, 1952, and not released by the corporation for exhibition. In view of the change of control of the corporation, the provisions of paragraph (d) (3) (ii) of this section are not significant at the time of the sale by D, and the Y corporation would be considered a collapsible corporation on January 2, 1953. See paragraphs (b) and (d) (1) of this section.

§ 39.117 (n) *Statutory provisions; gains and losses from sales or exchanges of securities by dealers in securities.*

SEC. 117. *Capital gains and losses.* * * *
(n) *Dealers in securities*—(1) *Capital gains.* Gain by a dealer in securities from the sale or exchange of any security shall in no event be considered as gain from the sale or exchange of a capital asset unless—

(A) The security was, prior to the expiration of the thirtieth day after the date of its acquisition or after the date of the enactment of the Revenue Act of 1951 (whichever is the later), clearly identified in the dealer's records as a security held for investment; and

(B) The security was not, at any time after the expiration of such thirtieth day, held by such dealer primarily for sale to customers in the ordinary course of his trade or business.

(2) *Ordinary losses.* Loss by a dealer in securities from the sale or exchange of any security shall, except as otherwise provided in subsection (i) (relating to bond, etc., losses of banks), in no event be considered as loss from the sale or exchange of property which is not a capital asset if at any time after the thirtieth day following the date of the enactment of the Revenue Act of 1951 the security was clearly identified in the dealer's records as a security held for investment.

(3) *Definition of security.* For the purposes of this subsection the term "security" means any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

[Sec. 117 (n) as added by sec. 327, Rev. Act 1951]

§ 39.117 (n)-1 *Dealers in securities*—(a) *Capital gain.* (1) The gain by a dealer in securities from the sale or exchange of a security shall in no event be considered to be gain from the sale or exchange of a capital asset unless—

(i) The security is, before the expiration of the thirtieth day after the date of its acqusition, or of the thirtieth day after October 20, 1951, whichever is later, clearly identified in the dealer's records as a security held for investment; and

(ii) The security is not, at any time after the expiration of such thirtieth day, held by the dealer primarily for sale to customers in the ordinary course of his trade or business.

(2) This provision is applicable only in the case where gain from the sale or exchange of a security would, but for such provision, be considered capital gain. Thus, if the sale of a security by a dealer would, but for section 117 (n) (1) be considered to constitute the sale of a security held for investment, gain from such sale will in no event be considered to be capital gain unless the security has been properly identified within the 30-day period in the dealer's records as being held for investment and such security is not at any time after the expiration of the 30-day period held by the dealer primarily for sale to customers in the ordinary course of his trade or business. However, the mere fact that a security which is actually held by a dealer for sale to customers in the ordinary course of his trade or business is identified as a security held for investment will not in and of itself cause the gain from the sale of the security to be treated as capital gain whether the security is sold within the 30-day period or after such period.

(b) *Ordinary loss.* (1) The loss sustained by a dealer in securities from the sale or exchange of a security shall in no event be considered to be loss from the sale or exchange of property which is not a capital asset if at any time after November 19, 1951, the security has been clearly identified in the dealer's records as a security held for investment. Once a security has been identified after November 19, 1951, as being held for investment, a loss on the subsequent disposition of such security shall in no event be considered an ordinary loss but shall be considered as one arising from the sale or exchange of a capital asset.

(2) Nothing in subparagraph (1) of this paragraph shall be taken to restrict or prohibit the application of section 117 (i) without regard to the manner in which the securities described therein have been identified in the records, to the net capital losses of a bank from sales or exchanges of bonds and certain other securities.

(c) *General.* (1) For the purpose of this section the term "security" means any share of stock in any corporation, any certificate of stock or interest in any corporation, any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing.

(2) A security is clearly identified in the dealer's records as a security held for investment when there is an accounting separation of such security from other securities. Accounting separation will be satisfied by (i) making appropriate entries in the dealer's books of account to distinguish the security from inventories and to carry it as an investment and (ii) indicating with such entries, to the extent feasible, the individual serial number of, or other characteristic symbol imprinted upon, the individual security.

(3) In computing the 30-day period within which the security must be clearly

identified, and after which such security may not be held primarily for sale to customers in the ordinary course of the trade or business, the first day of such period is the day following the date of acquisition. Thus, in the case of a security acquired on March 18, 1952, the 30-day period expires at midnight on April 17, 1952.

(4) For definition of a dealer in securities, see § 39.22 (c)-5.

§ 39.117 (o) *Statutory provisions; gain from sale of certain property between spouses or between an individual and a controlled corporation.*

SEC. 117. *Capital gains and losses.* * * *

(o) *Gain from sale of certain property between spouses or between an individual and a controlled corporation*—(1) *Treatment of gain as ordinary income.* In the case of a sale or exchange, directly or indirectly, of property described in paragraph (2)—

(A) Between a husband and wife; or

(B) Between an individual and a corporation more than 80 per centum in value of the outstanding stock of which is owned by such individual, his spouse, and his minor children and minor grandchildren;

any gain recognized to the transferor from the sale or exchange of such property shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in subsection (j).

(2) *Subsection applicable only to sales or exchanges of depreciable property.* This subsection shall apply only in the case of a sale or exchange of property by a transferor which in the hands of the transferee is property of a character which is subject to the allowance for depreciation provided in section 23 (l).

[Sec. 117 (o) as added by sec. 328, Rev. Act 1951]

§ 39.117 (o)-1 *Gain from sale or exchange of certain property between spouses or between an individual and a controlled corporation.* Section 117 (o) provides that any gain recognized to the transferor from the sale or exchange, directly or indirectly, between a husband and wife or between an individual and a controlled corporation, of property which, in the hands of the transferee, is property of a character subject to the allowance for depreciation provided in section 23 (l) (including such property with respect to which a deduction for amortization is allowable under section 23 (t)) shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 117 (j) For the purpose of section 117 (o) a corporation is controlled when more than 80 percent in value of all outstanding stock of the corporation is owned (whether legal ownership or beneficial ownership) by the taxpayer, his spouse, and his minor children and minor grandchildren. For the purpose of this rule, the terms "children" and "grandchildren" include stepchildren and legally adopted children. The provisions of section 117 (o) are applicable whether the property be transferred from the corporation to the shareholder or from the shareholder to the corporation.

§ 39.117 (p) *Statutory provisions; treatment of termination payments to employee.*

SEC. 117. *Capital gains and losses.* * * *

(p) *Taxability to employee of termination payments.* Amounts received from the assignment or release by an employee, after more than twenty years' employment, of all his rights to receive, after termination of his employment and for a period of not less than five years (or for a period ending with his death), a percentage of future profits or receipts of his employer shall be considered an amount received from the sale or exchange of a capital asset held for more than six months, if such rights were included in the terms of the employment of such employee for not less than twelve years, and if the total of the amounts received for such assignment or release are [is] received in one taxable year and after the termination of such employment.

[Sec. 117 (p) as added by sec. 329, Rev. Act 1951]

§ 39.117 (p)-1 *Capital gains treatment of certain termination payments.* Certain amounts received by an employee pursuant to the assignment or release by the employee of all his rights to receive, after termination of his employment and for a period of not less than five years or for a period ending with his death, a percentage of future profits or receipts of his employer, that is, profits or receipts attributable to a period subsequent to termination of employment, shall, under the provisions of section 117 (p) be considered and treated as an amount received from the sale or exchange of a capital asset held for more than six months. The provisions of section 117 (p) shall have application to such payments only if the following conditions are met:

(a) The employee was employed by the employer, in whose future profits or receipts the employee has an interest, for a period of more than 20 years before the assignment or release by the employee of his rights in such future profits or receipts,

(b) The full rights of the employee to the percentage of the future profits or receipts of such employer, which rights are the subject of the assignment or release, were incorporated in the terms of the contract of employment between the employee and the employer for a period of at least 12 years,

(c) The assignment or release was made after the termination of the employee's employment with such employer,

(d) The assignment or release conveyed all the rights of the employee in the future profits or receipts of such employer and conveyed no other rights of the employee, and

(e) The total amount to which the employee became entitled pursuant to the assignment or release was received by the employee after the termination of his employment with such employer and in one taxable year of the employee.

It is immaterial whether the contract of employment is oral or written provided the prescribed conditions are met. The requirement that the assignment or release be made after the termination of the employee's employment contemplates a complete and bona fide termination of the relationship of employer and employee and not merely, for example, a termination of such relationship under the particular contract or contracts of employment pursuant to which the employee acquired his rights in the future profits or receipts of the employer. The contract need not expressly provide that the employee shall share in the future profits or receipts of the employer for a minimum period of five years. However, if the contract does not expressly so provide and the assignment or release is made before the expiration of five years following the termination of employment, the terms of the contract considered in conjunction with the facts in the particular situation must establish that the rights of the employee to a percentage of future profits or receipts, in all probability, will extend to a period of not less than five years from the date of termination of employment or for a period ending with his death. Section 117 (p) has application only to an assignment or release made by the employee who acquired the right to a percentage of future profits or receipts of the employer, and has no application to amounts received other than as payment for assignment or release of such right. Section 117 (p) has no effect upon the determination of the income tax of the employer making the payment to the employee.

§ 39.118 *Statutory provisions; losses from wash sales of stock or securities.*

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.

§ 39.118-1 *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 end-

ing 30 days after such date (referred to in this section 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 § 39.22 (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 § 39.113 (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 section 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 section shall be disregarded in determining the deductibility of any other loss.

(f) The word "acquired" as used in this section 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.

(g) The following examples illustrate the application of this section:

Example (1). A, whose taxable year is the calendar year, on December 1, 1951, purchased 100 shares of common stock in the M Company for $10,000 and on December 15, 1951, purchased 100 additional shares for $9,000. On January 3, 1952, he sold the 100 shares purchased on December 1, 1951, 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, 1951, purchased 100 shares of the common stock of the M Company for $5,000. On December 21, 1951, he purchased 50 shares of substantially identical stock for $2,750, and on December 27, 1951, he purchased 25 additional shares of such stock for $1,125. On January 3, 1952, he sold for $4,000 the 100 shares purchased on September 21, 1951. 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, 1951, the acquisition of which resulted in the nondeductibility of the loss ($500) sustained on 50 of the 100 shares sold on January 3, 1952, is $2,500 (the cost of 50 of the shares sold on January 3, 1952) + $750 (the difference between the purchase price ($2,750) of the 50 shares acquired on December 21, 1951, and the selling price ($2,000) of 50 of the shares sold on January 3, 1952, or $3,250. Similarly, the basis of the 25 shares purchased on December 27, 1951, the acquisition of which resulted in the nondeductibility of the loss ($250) sustained on 25 of the shares sold on January 3, 1952, is $1,250+$125, or $1,375. See § 39.113 (a) (10)–1.

Example (3). A, whose taxable year is the calendar year, on September 15, 1950, purchased 100 shares of the stock of the M Company for $5,000. He sold these shares on February 1, 1952, for $4,000. On each of the four days from February 15, 1952, to February 18, 1952, inclusive, 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, 1952, 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, 1952, and the 50 shares purchased on February 16, 1952. In determining the period for which the 50 shares purchased on February 15, 1952, and the 50 shares purchased on February 16, 1952, were held, there is to be included the period for which the 100 shares purchased on September 15, 1950, and sold on February 1, 1952, were held.

PART II
Section 2

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Part II of this issue is divided into two sections. Section 1 contains §§ 39.1 through 39.118-1 of Part 39, Chapter I, Title 26, and Section 2 contains §§ 39.119 (a) through 39.6000-1.

TITLE 26, PART 39—Continued

§ 39.119 (a) *Statutory provisions; income from sources within the United States; gross income.*

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, 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 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 to the extent exceeding the amount which is 100/85ths of the amount of the credit allowable under section 26 (b) in respect of such dividends;

(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).

[Sec. 119 (a) as amended by sec. 160 (c), Rev. Act 1942; sec. 311 (b), Rev. Act 1951]

§ 39.119 (a)-1 *Interest.* (a) 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:

(1) 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;

(2) 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

(3) 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.

(b) Any taxpayer who excludes from gross income from sources within the United States income of the type specified in paragraph (a) (1) (2) or (3) of this section 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 therein.

(c) 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.

(d) 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 § 39.251 (b)-1.

§ 39.119 (a)-2 *Dividends.* (a) Gross income from sources within the United States includes dividends, as defined by section 115:

(1) From a domestic corporation other than one entitled to the benefits of section 251, and other than a corpora-

tion 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

(2) 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 purpose 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 to the extent exceeding the amount which is 100/85ths of the amount of the credit, if any allowable under section 26 (b) in respect of such dividends.

(b) Dividends will be treated as income from sources within the United States (except, for the purpose of section 131, to the extent indicated in paragraph (a) (2) of this section) unless the taxpayer submits sufficient data to establish to the satisfaction of the Commissioner that they should be excluded from gross income under paragraph (a) (1) or (2) of this section. See also section 116 (f)

§ 39.119 (a)-3 *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.

§ 39.119 (a)-4 *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.

§ 39.119 (a)-5 *Sale of real property.* Gross income from sources within the United States includes gain, computed under the provisions of sections 111 to 113, inclusive, 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.

§ 39.119 (a)-6 *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 section, 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 section 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 § 39.119 (e)-1.

§ 39.119 (a)-7 *Other income from sources within the United States.* (a) 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)

(b) 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 § 39.119 (e)-1.

(c) 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.

§ 39.119 (b) *Statutory provisions; income from sources within the United States; net income.*

SEC. 119. *Income from sources within United States.* * * *

(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.

§ 39.119 (b)-1 *Apportionment of deductions.* (a) From the items specified in section 119 (a) as being derived specifically from sources within the United States there shall, in the case of nonresident alien individuals and foreign corporations engaged in trade or business within the United States, 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 cannot 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 alien individual engaged in trade or business within the United States whose taxable year is the calendar year derived gross income from all sources for 1952 of $180,000, one-fifth of which ($36,000) was from sources within the United States as follows:

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

The remainder of the gross income was from sources without the United States, determined under § 39.119 (e)-1.

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.

The deductions provided for in chapter 1 shall be allowed to nonresident alien individuals and foreign corporations engaged in trade or business within the United States, 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.

§ 39.119 (c) *Statutory provisions; income from sources within the United States; gross income from sources without the United States.*

SEC. 119. *Income from sources within 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.

§ 39.119 (c)-1 *Income from sources without the United States.* Gross income from sources without the United States includes:

(a) Interest other than that specified in section 119 (a) (1) as being derived from sources within the United States;

(b) Dividends other than those derived from sources within the United States as provided in section 119 (a) (2)

(c) 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 § 39.119 (a)-3)

(d) 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, goodwill, trade-marks, trade brands, franchises, and other like property (see § 39.119 (a)-4), and

(e) Gain derived from the sale of real property located without the United States (see sections 111 to 113, inclusive).

§ 39.119 (d)-(e) *Statutory provisions; income from sources within the United States; net income from sources without the United States; income from sources partly within and partly without the United States.*

SEC. 119. *Income from sources within 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 can not 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 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. 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 can not 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.

§ 39.119 (e)-1 *Income from the sale of personal property derived from sources partly within and partly without the United States.* (a) Items of gross income not allocated by section 119 (a) or section 119 (c) 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: Class A, income derived from sources partly within the United States and partly within a foreign country, and class B, income derived from sources partly within the United States and partly within a possession of the United States.

(b) *Class A.* The portion of class A income derived from the production and sale of personal property which is attributable to sources within the United States shall be determined according to the rules and cases set forth in this paragraph. 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 set forth below. As used herein the word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged.

Case A1. 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 A2. Where an independent factory or production price has not been established as provided under case A1, 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 term "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 case A2, 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 A3. 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.

(c) *Class B.* The portion of class B income which is attributable to sources within the United States shall be determined according to the following rules and cases:

(1) *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 set forth below. As used herein the word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged.

Case B 1. Same as case A 1.

Case B 2. Where an independent factory or production price has not been established as provided under case A 1, 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 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 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 case B 2, 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 case B 2, includes only the property held or used to produce income which is derived from such sales.

Case B3. Same as case A3.

(2) *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 B4. 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 case B4, 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 B5. Same as case A3.

§ 39.119 (e)-2 *Transportation service.* (a) 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.

(b) The gross income from sources within the United States derived from services described in paragraph (a) of this section, shall be determined by taking such a portion of the total gross revenues therefrom as (1) 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 (2) 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.

(c) In allocating the total costs or expenses incurred in a transportation business described in paragraph (a) of this section, 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 Internal Revenue Code should be taken.

(d) 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.

(e) 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 (b) of this section, (1) the expenses of the transportation business carried on within the United States as determined under paragraph (b) of this section, and (2) the expenses determined in accordance with paragraphs (f) and (g) of this section.

(f) Interest and income, war-profits, and excess-profits taxes should be excluded from the apportionment process, as explained in paragraph (b) of this section; 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 (1) of all interest (deductible under section 23 (b)) and (2) 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.

(g) If a foreign corporation subject to this section 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 (b) of this section; 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.

(h) 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 section, 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 (b) to (g), inclusive, of this section the income derived from sources within the United States.

§ 39.119 (e)-3 *Telegraph and cable service*—(a) *In general.* 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.

(b) *Gross income.* The gross income from sources within the United States derived from services described in paragraph (a) of this section, shall be determined by adding (1) its gross revenues derived from messages originating in the United States and (2) 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.

(c) *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 (b) of this section, (1) 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, (2) 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) (3) depreciation of property (other than cables) located in the United States and used in the trade or business therein, and (4) a proportionate part of the general overhead expenses (not including any items incurred abroad corresponding to those enumerated in clauses (1), (2), and (3) of this sentence) 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.

§ 39.119 (e)-4 *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 investment applicable thereto, shall be segregated, and the net income from sources within the United States shall be separately computed therefrom.

§ 39.119 (f) *Statutory provisions; income from sources within the United States; definitions.*

SEC. 119. *Income from sources within 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."

§ 39.120 *Statutory provisions; unlimited deduction for charitable and other contributions.*

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 (determined without regard to subchapter E, relating to tax on self-employment income), war-profits, or excess-profits taxes paid during such year in respect of such year or 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 20 per centum limit imposed by section 23 (o) shall not be applicable.

[Sec. 120 as amended by sec. 208 (d) (6), Social Security Act Amendments 1950; Pub. Law 918 (81st Cong.) sec. 4 (b), Pub. Law 465 (82nd Cong.)]

§ 39.120-1 *Unlimited deduction for charitable and other contributions.* (a) Under the circumstances specified in section 120, the 20 percent limitation imposed by section 23 (o) on the deduction for charitable and other contributions is not applicable.

(b) The following rules shall apply with respect to the taxes included in determining for any taxable year whether the amount of the gifts, contributions, and taxes referred to in section 120 exceeds 90 percent of the net income computed without the benefit of any deduction for gifts or contributions:

(1) In the case of a taxable year beginning before January 1, 1943, there shall be included income, war-profits, and excess-profits taxes paid during such taxable year in respect of preceding taxable years.

(2) In the case of a taxable year beginning after December 31, 1942, there shall be included, in addition to the income, war-profits, and excess-profits taxes paid during such taxable year in respect of preceding taxable years, the amount of income tax paid during such taxable year in respect of such taxable year. For example, there shall be included the amount paid as estimated tax during the taxable year, to the extent such amount does not exceed the tax for such taxable year.

(3) In the case of a taxable year beginning after December 31, 1950, the amount of income tax paid during the taxable year shall be determined without regard to any payment of tax imposed under subchapter E of chapter 1 of the Internal Revenue Code, which subchapter relates to the tax on self-employment income.

(c) In the case of a husband and wife making a joint return for any taxable year, the 20 percent limitation imposed by section 23 (o) on the deduction for charitable and other contributions shall not be applicable 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) made by the husband and wife together during each such year plus the amount of the income, war-profits, or excess-profits taxes paid by the husband and wife together during each such year (determined under the rules of paragraph (b) of this section) exceeds 90 percent of the net income of the husband and wife together for each such year, as computed without the benefit of any deduction for contributions or gifts.

§ 39.121—122 *Statutory provisions; deductions of dividends paid on certain preferred stock of certain corporations; net operating loss deduction.*

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 chapter, 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).

Sec. 122. *Net operating loss deduction*—(a) *Definition of net operating loss.* As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) *Amount of carry-back and carry-over*—(1) *Net operating loss carry-back*—(A) *Loss for taxable year beginning before 1950.* * * *

(B) *Loss for taxable year beginning after 1949.* If for any taxable year beginning after December 31, 1949, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for the preceding taxable year.

(2) *Net operating loss carry-over*—(A) *Loss for taxable year beginning before 1948.* * * *

(B) *Loss for taxable year beginning after 1949.* If for any taxable year beginning after December 31, 1949, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the five succeeding taxable years, except that the carry-over in the case of each such succeeding taxable year (other than the first succeeding taxable year) shall be the excess, if any, of the amount of such net operating loss over the sum of the net income for each of the intervening years computed—

(i) With the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and

(ii) By determining the net operating loss deduction for each intervening taxable year, without regard to such net operating loss or to the net operating loss for any succeeding taxable year and without regard to any reduction specified in subsection (c).

For the purpose of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1949, shall be reduced by the amount, if any, of the net income for the preceding taxable year computed—

(i) With the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and

(ii) By determining the net operating loss deduction for such preceding taxable year without regard to such net operating loss and without regard to any reduction specified in subsection (c).

(C) *Loss for taxable year beginning after December 31, 1947 and before January 1, 1950.* If for any taxable year beginning after December 31, 1947, and before January 1, 1950, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the three succeeding taxable years, except that the carry-over in the case of each such succeeding taxable year (other than the first succeeding taxable year) shall be the excess, if any, of the amount of such net operating loss over the sum of the net income for each of the intervening years computed—

(i) With the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and

(ii) By determining the net operating loss deduction for each intervening taxable year without regard to such net operating loss or to the net operating loss for any succeeding taxable year and without regard to any reduction specified in subsection (c).

For the purpose of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1947, and before January 1, 1950, shall be reduced by the sum of the net income for each of the two preceding taxable years computed—

(iii) With the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and

(iv) By determining the net operating loss deduction without regard to such net operating loss or to the net operating loss for the succeeding taxable year, and without regard to any reduction specified in subsection (c).

(D) *Loss for taxable year beginning after December 31, 1946, and before January 1, 1948, in the case of a corporation which commenced business after December 31, 1945.* * * *

(c) *Amount of net operating loss deduction.* The amount of the net operating loss deduction shall be the aggregate of the net operating loss carry-overs and of the net operating loss carry-backs to the taxable year reduced by the amount, if any, by which the net income (computed with the exceptions and limitations provided in subsection (d) (1), (2), (3), and (4)) exceeds, in the case of a taxpayer other than a corporation, the net income (computed without such deduction), or, in the case of a corporation, the normal-tax net income (computed without such deduction and without the credits provided in section 26 (h) and (i));

(d) *Exceptions, additions, and limitations.* The exceptions, additions, and limitations referred to in subsections (a), (b), and (c) shall be as follows:

(1) 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);

(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this chapter, 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;

(3) No net operating loss deduction shall be allowed;

(4) The amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible

on account of gains from such sales or exchanges. The deduction provided in section 23 (ee) shall not be allowed.

(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions and limitations specified in paragraphs (1) to (4) of this subsection. This paragraph shall not apply with respect to deductions allowable for losses sustained after December 31, 1950, in respect of property, if the losses arise from fire, storm, shipwreck, or other casualty, or from theft.

(6) * * * [Not applicable to taxable years ending after June 30, 1950]

(e) *No carry-back to year prior to 1941.* * * *

[Sec. 122 as added by sec. 211 (b), Rev. Act 1939, amended by secs. 105 (e) (3), 150 (e), and 153 (a) (b) (c), Rev. Act 1942; secs. 121 (g) (2) and 215 (a), Rev. Act 1950; sec. 304 (e), Excess-Profits Tax Act 1950; secs. 322 (c) (4), 330, and 344, Rev. Act 1951]

§ 39.122-1 *Net operating loss deduction*—(a) *General.* (1) Section 122 provides the rules for the computation of the net operating loss deduction allowed by section 23 (s). The net operating loss deduction is the aggregate of the net operating loss carry-overs and carry-backs to the taxable year, reduced by certain adjustments to prevent the deduction of losses absorbed by income not taxed.

(2) Section 122 provides that the aggregate of the net operating loss carry-overs and carry-backs to a taxable year shall be the basis of the net operating loss deduction. See § 39.122-4 for the taxable years from which a net operating loss may be carried over or carried back to the current taxable year. The amount of the net operating loss which may be carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed by the net income for the other taxable years, preceding such taxable year, to which it was carried back or carried over. If the net operating losses for several taxable years are carried back or carried over to one taxable year, they are considered to be applied in reduction of the net income for such taxable year in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

(3) A fractional part of a year which is a taxable year under section 48 (a) is a preceding or a succeeding taxable year for the purpose of determining under section 122 the first, second, etc., preceding or succeeding taxable year.

(4) Every taxpayer claiming a net operating loss deduction for any taxable year shall file with his return for such year a concise statement setting forth the amount of the net operating loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the net operating loss deduction.

(b) *Steps in computation of net operating loss deduction.* There are three steps in the ascertainment of the net operating loss deduction. The first step is the computation of the net operating loss, if any, for any preceding or succeeding taxable year from which a net operating loss may be carried over or carried back to the current taxable year. The second is the computation of the net operating loss carry-overs to the taxable year from such preceding taxable years and the computation of the net operating loss carry-back to the taxable year from the first succeeding taxable year. The third is the conversion of the aggregate of such net operating loss carry-overs and carry-back into the net operating loss deduction.

(c) *Ascertainment of deduction dependent upon net operating loss carry-back.* If the taxpayer is entitled in computing his net operating loss deduction to a carry-back which he is not able to ascertain at the time his return is due, he shall compute the net operating loss deduction on the return without regard to such net operating loss carry-back. When the taxpayer ascertains the net operating loss carry-back, he may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the net operating loss deduction for the taxable year with the inclusion of such carry-back. Under the provisions of section 3771 (e), no interest is allowed with respect to any such overpayment for the period before the filing of the claim for credit or refund of such overpayment or before the filing of a petition with The Tax Court of the United States asserting such overpayment, whichever is earlier.

§ 39.122-2 *Computation of net operating loss in case of corporation.* (a) A net operating loss is sustained by a corporation in any taxable year if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 over gross income, both computed with the following exceptions, additions, and limitations:

(1) 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).

(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by chapter 1, 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; and

(3) No net operating loss deduction shall be allowed.

(b) The application of this section may be illustrated by the following example:

Example. For the year 1952 the X Corporation, which makes its income tax returns on the calendar year basis, has gross income as defined in section 22 of $400,000 and deductions allowed by section 23 of $600,000, exclusive of any net operating loss deduction. The X Corporation deducted $75,000 for depletion on a percentage basis. If depletion had been computed without reference to percentage depletion, the amount of such deduction would have been $5,000. For 1952 the X Corporation also had $35,000 of wholly tax-exempt interest, and paid $15,000 in interest on indebtedness incurred to carry the obligations from which such tax-exempt interest was derived. On the basis of these facts the X Corporation has a net operating loss for the year 1952 of $110,000, computed as follows:

(1) Deductions for 1952		$600,000
(2) Less: Excess of percentage depletion over cost ($75,000 minus $5,000)		70,000
(3) Deductions adjusted as required by section 122 (d) (item (1) minus item (2))		530,000
(4) Gross income for 1952	$400,000	
(5) Plus tax-exempt interest minus interest paid ($35,000 minus $15,000)	20,000	
(6) Gross income adjusted as required by section 122 (d) (item (4) plus item (5))		420,000
(7) Net operating loss for 1952 (item (3) minus item (6))		110,000

§ 39.122-3 *Computation of net operating loss in case of a taxpayer other than a corporation*—(a) *In General.* A net operating loss is sustained by a taxpayer other than a corporation in any taxable year if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 over gross income, both computed with the following exceptions, additions, and limitations:

(1) 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)

(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by chapter 1, 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;

(3) No net operating loss deduction shall be allowed;

(4) (i) The deduction provided in sections 23 (ee) and 117 (b) shall not be allowed;

(ii) The amount deductible on account of business capital losses shall not exceed the amount includible on account of business capital gains, plus a portion of any nonbusiness capital gains, computed in accordance with paragraph (c) of this section;

(iii) The amount deductible on account of nonbusiness capital losses shall not exceed the amount includible on account of nonbusiness capital gains; and

(5) Ordinary nonbusiness deductions (i. e., exclusive of capital losses) shall be allowed only to the extent of the amount of ordinary nonbusiness gross income

(i. e., exclusive of capital gains) plus the excess, if any of nonbusiness capital gains over nonbusiness capital losses. For the purpose of computing the net operating loss deduction, any deduction allowable for a loss sustained after December 31, 1950, in respect of property, if the loss arises from fire, storm, shipwreck, or other casualty or from theft, shall not be considered to be an ordinary nonbusiness deduction but shall be treated as a deduction attributable to the operation of a trade or business regularly carried on by the taxpayer.

(b) *Treatment of net capital loss carry-overs.* (1) Because of the distinction between business and nonbusiness capital gains and losses, a taxpayer who has a net capital loss carry-over from preceding taxable years, includible among the short-term capital losses for the current taxable year by virtue of section 117 (e) must determine how much of such net capital loss carry-over is a business capital loss and how much is a nonbusiness capital loss. In order to make this determination, the taxpayer must first ascertain what proportion of the net capital losses for such preceding taxable years was attributable to an excess of business capital losses over business capital gains for such years, and what proportion was attributable to an excess of nonbusiness capital losses over nonbusiness capital gains. The same proportion of the net capital loss carry-over from any such preceding taxable years shall be treated as a business capital loss and a nonbusiness capital loss, respectively.

(2) This rule may be illustrated by the following example:

Example. (i) A, an individual, has $5,000 ordinary net income for the calendar year 1952 and also has the following capital gains and losses for such year: Business capital gains of $2,000; business capital losses of $3,200; nonbusiness capital gains of $1,000; and nonbusiness capital losses of $1,200.

(ii) A's net capital loss for the taxable year 1952 is $400, computed as follows:

Total capital losses	$4,400
Total capital gains	3,000
Excess of total capital losses over total capital gains	1,400
Less: $1,000 of ordinary net income	1,000
Net capital loss for 1952	400

(iii) A's total capital losses for 1952 exceeded his total capital gains for such year by $1,400 ($4,400 minus $3,000). Since A's business capital losses for 1952 ($3,200) exceeded his business capital gains ($2,000) for such year by $1,200 6/7ths (1,200/1,400) of A's net capital loss for 1952 was attributable to an excess of his business capital losses over his business capital gains for such year. Similarly, 1/7th of the net capital loss is attributable to the excess of nonbusiness capital losses over nonbusiness capital gains. Since the net capital loss carry-over from 1952 to 1953 is $400, 6/7ths of $400, or $342.86, will be treated as a business capital loss in 1953, and 1/7th of $400, or $57.14, as a nonbusiness capital loss.

(c) *Determination of portion of nonbusiness capital gains available for the deduction of business capital losses.* (1) In the computation of a net operating loss a taxpayer other than a corporation must use his nonbusiness capital gains for the deduction of his nonbusiness capital losses. See paragraph (a) (4) (iii) of this section. Any amounts not necessary for this purpose shall then be used for the deduction of any excess of ordinary nonbusiness deductions over ordinary nonbusiness gross income. See paragraph (a) (5) of this section. The remainders, computed by applying the excess ordinary nonbusiness deductions against the excess capital gains, shall be treated as capital gains and may be used for the purpose of determining the deductibility of business capital losses under paragraph (a) (4) (ii) of this section.

(2) This principle may be illustrated by the following example:

Example. (i) A, an individual, has a total nonbusiness gross income of $20,500, computed as follows:

Ordinary gross income	$7,500
Capital gains	13,000
Total gross income	20,500

(ii) He also has total nonbusiness deductions of $16,000, computed as follows:

Ordinary deductions	$9,000
Capital losses	7,000
Total deductions	16,000

(iii) In order to determine the portion of the nonbusiness capital gains available for the deduction of business capital losses there must first be deducted the amounts of the nonbusiness capital losses. It is then found that the excess capital gains amount to $6,000 ($13,000 minus $7,000). Since the ordinary nonbusiness deductions exceed the ordinary nonbusiness gross income by $1,500 ($9,000 minus $7,500), $1,500 of the $6,000 excess capital gains must be used to permit the allowance of such $1,500 under paragraph (a) (5) of this section. Therefore, $1,500 excess of ordinary deductions over ordinary gross income will be deducted from the $6,000 of excess capital gains, leaving $4,500 to be added to the business capital gains for the purpose of determining the deductibility of any business capital loss.

(d) *Illustration of computation of net operating loss by a taxpayer other than a corporation.* (1) A, an individual, who makes his income tax returns on a calendar year basis, has for 1952 gross income of $483,000 and deductions (exclusive of any deductions attributable to capital losses and exclusive of the net operating loss deduction) of $540,000. Included in gross income are business capital gains of $50,000 and nonbusiness income of $10,000. Included among the deductions are deductions of $12,000 incurred in transactions not connected with a trade or business. A has a business capital loss of $60,000 in 1952. A also received $25,000 of interest on State bonds in 1952 which is wholly exempt from Federal income tax. A has no other items of income or deductions to which section 122 (d) is applicable.

(2) On the basis of these facts A has a net operating loss for 1952 of $80,000, computed as follows:

(i) Deductions for 1952 (exclusive of any deductions attributable to capital losses and exclusive of the net operating loss deduction)		$540,000
(ii) Plus amount of capital loss ($60,000) to extent such amount does not exceed capital gains ($50,000)		50,000
(iii) Sum of item (i) and item (ii)		590,000
(iv) Less excess of nonbusiness deductions over nonbusiness gross income ($12,000 minus $10,000)		2,000
(v) Deductions for 1952 adjusted as required by section 122 (d) (item (iii) minus item (iv))		588,000
(vi) Gross income for 1952	$483,000	
(vii) Plus tax-exempt interest	25,000	
(viii) Gross income for 1952 adjusted as required by section 122 (d) (item (vi) plus item (vii))		508,000
(ix) Net operating loss for 1952 (item (v) minus item (viii))		80,000

(3) For treatment of depletion deductions, see example in § 39.122-2. For treatment of net capital loss carry-over, nonbusiness capital gains and losses, and the portion of the nonbusiness capital gains which may be used to permit the deduction of business capital losses, see examples in paragraphs (b) and (c) of this section.

(e) *Joint return by husband and wife.* In the case of a husband and wife, the joint net operating loss for any taxable year for which a joint return is filed is to be computed upon the basis of the combined income and deductions of both spouses, and the exceptions, additions, and limitations prescribed by section 122 (d) are to be computed as if the combined income and deductions of both spouses were the income and deductions of one individual.

§ 39.122-4 *Computation of net operating loss carry-overs and net operating loss carry-back*—(a) *In general.* (1) The aggregate of the net operating loss carry-overs and the net operating loss carry-back to a taxable year shall be the basis of the net operating loss deduction. In order to compute such deduction the taxpayer must first determine the part of any net operating losses for any preceding or succeeding taxable years which are carry-overs or a carry-back to the current taxable year.

(2) The number of taxable years to which a net operating loss may be carried back and carried over are as follows:

Net operating loss for a taxable year beginning:		May be carried back to the following preceding taxable years	May be carried over to the following succeeding taxable years
After	Before		
Dec. 31, 1948	Jan. 1, 1950	2	3
Dec. 31, 1949		1	5

(3) The amount which is carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed in the computation of the net income for other taxable years,

preceding such taxable year, to which it was carried back or carried over. For the purpose of determining the net income for a taxable year which so absorbs the net operating loss that is carried back or carried over, the various net operating loss carry-overs and carry-backs to such taxable year are considered to be applied in reduction of the net income for such taxable year in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

(b) *Portion of net operating loss which is a carry-over or a carry-back to the current taxable year.* A net operating loss must first be carried to the earliest of the several taxable years to which such loss is allowable as a carry-back or a carry-over, and is then to be carried to the next earliest of such several taxable years, etc. See paragraph (a) of this section for the taxable years to which a net operating loss incurred in any particular taxable year may be carried back or carried over. The entire net operating loss may be carried to such earliest year. The portion of the loss which may be carried to any taxable year subsequent to such earliest year is the excess of such net operating loss over the aggregate of the net income, if any (computed as provided in paragraph (c) of this section) for those of such several taxable years which precede the taxable year to which such net operating loss is allowable as a carry-back or a carry-over.

Example. A taxpayer on the calendar year basis has a net operating loss for 1952. The entire net operating loss for 1952 may be carried back to 1951. The amount of the carry-over to 1953 is the excess of the 1952 loss over the net income (computed as provided in paragraph (c) of this section) for 1951. Similarly, the amount of the carry-over to 1954, 1955, 1956, and 1957 is the excess of the 1952 loss over the aggregate of the net income (computed as provided in paragraph (c) of this section) for 1951 and 1953, for 1951, 1953 and 1954, for 1951, 1953, 1954, and 1955, and for 1951, 1953, 1954, 1955, and 1956, respectively.

(c) *Computation of net income which is subtracted from net operating loss to determine carry-back or carry-over.* The net income for any taxable year which is subtracted from the net operating loss for another taxable year to determine the portion of such net operating loss which is a carry-back or carry-over to a particular taxable year as provided in paragraph (b) of this section is computed with the following adjustments:

(1) The net operating loss deduction for such taxable year is computed (i) by taking into account only such net operating losses otherwise allowable as carry-overs or a carry-back to such taxable year as were sustained in taxable years preceding the taxable year in which the taxpayer sustained the net operating loss from which the net income is to be deducted, and (ii) by disregarding the adjustment provided in section 122 (c) and § 39.122-5 (relating to the conversion of the aggregate of the net operating loss carry-overs and carry-back to the taxable year into the net operating loss deduction).

Example. The taxpayer files its income tax returns on the basis of the calendar year. In computing the net operating loss deduction for 1952, the taxpayer has a carry-over from 1950 of $9,000, a carry-over from 1951 of $6,000, and a carry-back from 1953 of $18,000, or an aggregate of $33,000 in carry-overs and a carry-back which is the basis for the deduction. The adjustment under section 122 (c) for the purpose of computing the net operating loss deduction for 1952 is $2,500. In computing the net income for 1952 which is deducted from the net operating loss for 1953 for the purpose of determining the amount of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1952 is $15,000, that is, the aggregate of the $9,000 carry-over from 1950 and the $6,000 carry-over from 1951. In computing such net operating loss deduction for such purpose, the $18,000 carry-back from 1953 and the adjustment required by section 122 (c) are each disregarded.

(2) In the case of a corporation, the net income shall be computed in accordance with the exceptions, additions, and limitations applicable in the computation of a net operating loss (see § 39.122-2), except that the net operating loss deduction shall be allowed to the extent provided in subparagraph (1) of this paragraph.

(3) In the case of a taxpayer other than a corporation, the net income and adjusted gross income shall be computed in accordance with the exceptions, additions, and limitations specified in subparagraphs (1), (2), (3) and (4) (i) of paragraph (a) of § 39.122-3, except that the net operating loss deduction shall be allowed to the extent provided in subparagraph (1) of this paragraph. In lieu of the last exceptions specified in subparagraphs (4) (ii) (4) (iii) and (5) of paragraph (a) of § 39.122-3, the taxpayer is required only to restrict the amount of his deduction for capital losses to the amount of his capital gains. The ordinary non-business deductions are allowed in full if otherwise allowable by law. The exceptions and limitations dependent upon the distinction between business and non-business items of gross income and deductions are not applicable in the computation of the net income to be subtracted in computing carry-backs and carry-overs.

(4) Any deduction which is limited in amount to a percentage of the taxpayer's net income or adjusted gross income shall be recomputed upon the basis of the net income or adjusted gross income, as the case may be, determined with the adjustments prescribed in subparagraphs (1), (2), and (3) of this paragraph.

(5) The net income, as adjusted, shall in no case be considered less than zero.

(d) *Illustration of computation of net operating loss carry-back and carry-overs.* The application of this section may be illustrated by the following example:

Example. The taxpayer is a corporation making its income tax returns on the calendar year basis. It had no net operating loss in 1949, 1950, or 1951, or in 1962. Its net income, computed without any net operating loss deduction (it being assumed that none of the other adjustments provided in paragraph (c) of this section is applicable), was $20,000 in 1952, $15,000 in 1954, $30,000 in 1955, $20,000 in 1957, $10,000 in 1958, $30,000 in 1959, $35,000 in 1960, and $75,000 in 1961. It sustained net operating losses of $75,000 in 1953 and $150,000 in 1956. It is assumed for the purposes of this example that the application of § 39.122-5 does not cause any reduction of the amount of the aggregate of the net operating loss carry-overs and the net operating loss carry-back to any taxable year, so that such aggregate is the net operating loss deduction for such taxable year.

(1) The portions of the $75,000 net operating loss for 1953 which may be used as a carry-back to 1952 and as carry-overs to 1954, 1955, 1956, 1957, and 1958 are computed as follows:

(i) For 1952, the carry-back is $75,000, that is, the amount of the net operating loss.

(ii) For 1954, the carry-over is $55,000, that is, the excess of the $75,000 net operating loss over the $20,000 net income for 1952 (such net income being determined without any net operating loss deduction since there is no carry-over to 1952 from 1949, 1950, or 1951, and the carry-back from 1953 is not taken into account).

(iii) For 1955, the carry-over is $40,000, that is, the excess of the $75,000 net operating loss over $35,000, the sum of the $20,000 net income for 1952 (computed without the deduction of the carry-back from 1953) and the $15,000 net income for 1954 (computed without the deduction of the carry-over from 1953).

(iv) For 1956, the carry-over is $10,000, that is, the excess of the $75,000 net operating loss over $65,000, the sum of the $20,000 net income for 1952 (computed without the deduction of the carry-back from 1953), the $15,000 net income for 1954 (computed without the deduction of the carry-over from 1953), and the $30,000 net income for 1955 (computed without the deduction of the carry-over from 1953 or the carry-back from 1956).

(v) For 1957, the carry-over is $10,000, that is, the excess of the $75,000 net operating loss over $65,000, the sum of the $20,000 net income for 1952 (computed without the deduction of the carry-back from 1953), the $15,000 net income for 1954 (computed without the deduction of the carry-over from 1953), the $30,000 net income for 1955 (computed without the deduction of the carry-over from 1953 or the carry-back from 1956), and the $0 net income for 1956 (a year in which a net operating loss was sustained).

(vi) For 1958, there is no carry-over of the net operating loss for 1953 since such loss does not exceed $85,000, the sum of the net incomes for the first taxable year preceding 1953 and the first four taxable years following 1953 computed as provided in paragraph (c) of this section (the $20,000 net income for 1952, the $15,000 net income for 1954, the $30,000 net income for 1955, and the $20,000 net income for 1957, there being no net operating loss deduction for any of such taxable years since the carry-back and carry-overs from 1953, the year of the net operating loss, and from 1956, a year subsequent to the year of the net operating loss, are not taken into account).

(2) The portions of the $150,000 net operating loss for 1956 which may be used as a carry-back to 1955 and as carry-overs to 1957, 1958, 1959, 1960, and 1961 are computed as follows:

(i) For 1955, the carry-back is $150,000, that is, the amount of the net operating loss.

(ii) For 1957, the carry-over is $150,000, that is, the excess of the $150,000 net operating loss over the $0 net income for 1955 (such net income for 1955 being computed as the $30,000 income reduced by the carry-over of $40,000 from 1953).

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(iii) For 1958, the carry-over is $140,000, that is, the excess of the $150,000 net operating loss over $10,000, the sum of the $0 net income for 1955 (such net income for 1955 being computed as the $30,000 income reduced by the carry-over of $40,000 from 1953) and the $10,000 net income for 1957 (such net income for 1957 being computed as the $20,000 income reduced by the $10,000 carry-over from 1953, the $150,000 carry-over from 1956 to 1957 not being taken into account).

(iv) For 1959, the carry-over is $130,000, that is, the excess of the $150,000 net operating loss over $20,000, the sum of the $0 net income for 1955 (such net income for 1955 being computed as the $30,000 income reduced by the carry-over of $40,000 from 1953), the $10,000 net income for 1957 (such net income for 1957 being computed as the $20,000 income reduced by the carry-over of $10,000 from 1953, the $150,000 carry-over from 1956 to 1957 not being taken into account), and the $10,000 net income for 1958 (the $140,000 carry-over from 1956 to 1958 not being taken into account).

(v) For 1960, the carry-over is $100,000, that is, the excess of the $150,000 net operating loss over $50,000, the sum of the $0 net income for 1955 (such net income for 1955 being computed as the $30,000 income reduced by the carry-over of $40,000 from 1953), the $10,000 net income for 1957 (such net income for 1957 being computed as the $20,000 income reduced by the carry-over of $10,000 from 1953, the $150,000 carry-over from 1956 to 1957 not being taken into account), the $10,000 net income for 1958 (the $140,000 carry-over from 1956 to 1958 not being taken into account), and the $30,000 net income for 1959 (the $130,000 carry-over from 1956 to 1959 not being taken into account).

(vi) For 1961, the carry-over is $65,000, that is, the excess of the $150,000 net operating loss over $85,000, the sum of the $0 net income for 1955 (such net income for 1955 being computed as the $30,000 income reduced by the carry-over of $40,000 from 1953), the $10,000 net income for 1957 (such net income for 1957 being computed as the $20,000 income reduced by the carry-over of $10,000 from 1953, the $150,000 carry-over from 1956 to 1957 not being taken into account), the $10,000 net income for 1958 (the $140,000 carry-over from 1956 to 1958 not being taken into account), the $30,000 net income for 1959 (the $130,000 carry-over from 1956 to 1959 not being taken into account), and the $35,000 net income for 1960 (the $100,000 carry-over from 1956 to 1960 not being taken into account).

(3) (i) For 1952, the net operating loss deduction is determined to be $75,000, that is, the carry-back from 1953.

(ii) For 1954, the net operating loss deduction is determined to be $55,000, that is, the carry-over from 1953.

(iii) For 1955, the net operating loss deduction is determined to be $190,000, that is, the aggregate of the $40,000 carry-over from 1953 and the $150,000 carry-back from 1956.

(iv) For 1957, the net operating loss deduction is determined to be $160,000, that is, the aggregate of the carry-over of $10,000 from 1953 and of the carry-over of $150,000 from 1956.

(v) For 1958, the net operating loss deduction is determined to be $140,000, that is, the carry-over from 1956.

(vi) For 1959, the net operating loss deduction is determined to be $130,000, that is, the carry-over from 1956.

(vii) For 1960, the net operating loss deduction is determined to be $100,000, that is, the carry-over from 1956.

(viii) For 1961, the net operating loss deduction is determined to be $65,000, that is, the carry-over from 1956.

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(e) *Joint return by husband and wife.* (1) If a husband and wife making a joint return for any taxable year did not make a joint return for any of the taxable years involved in the computation of a net operating loss carry-over or a net operating loss carry-back to the taxable year for which the joint return is made, such separate net operating loss carry-over or separate net operating loss carry-back is a joint net operating loss carry-over or joint net operating loss carry-back to such taxable year.

(2) If a husband and wife making a joint return for a taxable year made a joint return for each of the taxable years involved in the computation of a net operating loss carry-over or net operating loss carry-back to such taxable year, the joint net operating loss carry-over or joint net operating loss carry-back to such taxable year is computed in the same manner as the net operating loss carry-over or net operating loss carry-back of an individual under paragraphs (a) to (d) inclusive, of this section but upon the basis of the joint net operating losses and the combined net income of both spouses.

(3) If a husband and wife making separate returns for a taxable year made a joint return for any or all of the taxable years involved in the computation of a net operating loss carry-over or net operating loss carry-back, the separate net operating loss carry-over or separate net operating loss carry-back of each spouse to the taxable year is computed in the manner set forth in paragraphs (a) to (d) inclusive, of this section, but with the following exceptions and limitations:

(i) The net operating loss of each spouse for a taxable for which a joint return was made shall be deemed to be the portion of the joint net operating loss (computed in accordance with paragraph (e) of § 39.122–3) attributable to the gross income and deductions of such spouse, both gross income and deductions being taken into account to the same extent that they are taken into account in computing the joint net operating loss.

(ii) The net income of a particular spouse for any taxable year which is subtracted from the net operating loss of such spouse for another taxable year in order to determine the amount of such such loss which may be carried back or carried over to still another taxable year is deemed to be, in a case in which such net income was reported in a joint return, the sum of the following:

(*a*) The portion of the combined net income of both spouses for such year for which the joint return was made which is attributable to the gross income and deductions of the particular spouse, both gross income and deductions being taken into account to the same extent that they are taken into account in computing such combined net income, and

(*b*) The portion of such combined net income attributable to the other spouse, but if such other spouse has a taxable year beginning on the same date as the taxable year in which the particular spouse sustained the net operating loss from which the net income is subtracted, and if such other spouse sustained a net operating loss in such taxable year, then such portion shall first be reduced by such net operating loss of such other spouse. However, such net operating loss of such other spouse shall first be diminished by the excess, if any, of the reduction provided in section 122 (c) for the year in which the net income was realized over the aggregate of the net opearting loss carry-overs and net operating loss carry-backs which are taken into account in computing the net operating loss deduction for such taxable year (see (*d*) of this subdivision)

For the purposes of subdivisions (*a*) and (*b*) of this subdivision, the combined net income shall be computed as though the combined income and deductions of both spouses were those of one individual, and in such computation:

(*c*) The exceptions, additions, and limitations provided in section 122 (d) (1) (2) and (4) shall apply, and

(*d*) The net operating loss deduction shall be determined without taking into account any net operating loss of either spouse or any joint net operating loss of both spouses which was sustained in a taxable year beginning on or after the date of the beginning of the taxable year in which the particular spouse sustained the net operating loss from which the net income is subtracted.

(4) In the following examples, which illustrate subdivisions (i) and (ii) of subparagraph (3) of this paragraph, it is assumed that there are no items of adjustment under section 122 (d) (1), (2), and (4) and the net income or loss in each case is the net income or loss determined without any net operating loss deduction. The taxpayer in each example, H, a husband, and W, his wife, report their income on the calendar year basis.

Example (1). H and W filed joint returns for 1952 and 1953. They sustained a joint net operating loss of $1,000 for 1952 and a joint net operating loss of $2,000 for 1953. For 1952 the deductions of H exceeded his gross income by $700, and the deductions of W exceeded her gross income by $300, the total of such amounts being $1,000. Therefore, $700 of the $1,000 joint net operating loss for 1952 is considered the net operating loss of H for 1952, and $300 of such joint net operating loss is considered the net operating loss of W for 1952. For 1953 the gross income of H exceeded his deductions, so that his separate net income would be $1,500, and the deductions of W exceeded her gross income by $3,500. Therefore, all of the $2,000 joint net operating loss for 1953 is considered the separate net operating loss of W for 1953.

Example (2). (i) H and W filed joint returns for 1949 and 1951, and separate returns for 1950 and 1952. For such years they had net incomes and net operating losses as follows:

	1949	1950	1951	1952
H	[1] $5,000	[1] $2,500	[2] $6,500	[1] $4,000
W	[1] 3,000	[2] 2,000	[2] 3,000	[1] 1,500
	[3] 8,000	----------	[4] 9,500	----------

[1] Loss.
[2] Income.
[3] Joint loss.
[4] Combined income.

(ii) The net operating loss carry-over of H from 1952 to 1953 is $4,000, that is, his $4,000 net operating loss for 1952 which is not reduced by any part of the net income for 1951, since none of such net income is attributable to H and the portion attributable to W is entirely offset by her separate net operating loss deduction for her taxable year 1952, which taxable year begins on the same date as H's taxable year 1952. The determination of the amount ($0) of net income for 1951 which reduces H's net operating loss for 1952 is made as follows:

(iii) The combined net income of $9,500 for 1951 is reduced to $1,000 by the net operating loss deduction for such year of $8,500. This net operating loss deduction is computed without taking into account any net operating loss sustained in a taxable year beginning on or after January 1, 1952, the date of the beginning of the taxable year in which H sustained the net operating loss which is a carry-over to 1953. This $8,500 amount is composed of H's carry-overs of $5,000 from 1949 and $2,500 from 1950, or a total of $7,500, and of W's carry-over of $1,000 from 1949 (the excess of W's $3,000 loss for 1949 over her $2,000 income for 1950). None of the $1,000 combined net income for 1951 (computed with the net operating loss deduction described above) is attributable to H since it is caused by W's income (computed after deducting her separate carry-over) offsetting H's loss (computed by deducting from his income his separate carry-overs). No part of the $1,000 net income for 1951 which is attributable to W is used to reduce H's net operating loss for 1952 since such net income attributable to W must first be reduced by W's $1,500 net operating loss for 1952, her taxable year beginning on the same date as the taxable year of H in which he sustained the net operating loss from which the net income is subtracted.

(iv) The net operating loss carry-over of W from 1952 to 1953 is $500, her $1,500 loss reduced by the $1,000 net income for 1951, computed in the manner prescribed in subdivision (iii) of this example, since all of such net income is attributable to her.

Example (3). (i) Assume the same facts as in example (2), except that for 1952 the net operating loss of W is $200 instead of $1,500.

(ii) The net operating loss carry-over of H from 1952 to 1953 is $3,200, that is, his $4,000 net operating loss reduced by $800 of the net income for 1951 computed as follows:

(iii) The combined net income for 1951, computed with the net operating loss deduction in the manner described in example (2), remains $1,000, no part of which is attributable to H. To the $0 net income attributable to H, there is added $800, the excess of the $1,000 net income attributable to W over her $200 net operating loss sustained in 1952, a taxable year beginning on the same date (January 1, 1952) as the taxable year of H (1952) in which he sustained the $4,000 net operating loss from which the net income is subtracted. See subparagraph (3) (ii) (*b*) of this paragraph.

(iv) W has no net operating loss carry-over from 1952 to 1953 since her net operating loss of $200 for 1952 does not exceed the $1,000 net income for 1951 attributable to her.

Example (4). (i) Assume the same facts as in example (2), except that W changes her accounting period in 1952 to a fiscal year ending on January 31, and has neither income nor losses for the taxable year January 1, 1952, to January 31, 1952, but has a net operating loss of $200 for the fiscal year February 1, 1952, to January 31, 1953.

(ii) The net operating loss carry-over of H from 1952 to 1953 is $3,000, that is, his net operating loss of $4,000 for 1952 reduced by the $1,000 net income for 1951, computed as follows:

(iii) The combined net income for 1951, computed with the net operating loss deduction in the manner described in example (2), remains $1,000, no part of which is attributable to H. To the $0 net income attributable to H there is added the $1,000 net income attributable to W. The net income attributable to W is not reduced by any amount since she does not have a net operating loss for her taxable year beginning on January 1, 1952, the date of the beginning of the taxable year of H in which he sustained the $4,000 net operating loss from which the net income is deducted.

(iv) The net operating loss carry-over of W from the fiscal year beginning February 1, 1952, to her next fiscal year is $200, her net operating loss for such year. This net operating loss is not reduced by any amount of net income for any prior taxable year since W's net income, without regard to any net operating loss deduction for the taxable year January 1, 1952, to January 31, 1952, was zero, and since her net operating loss for the fiscal year beginning February 1, 1952, may be carried back only to the immediately preceding taxable year and accordingly cannot be carried back to any taxable year beginning before January 1, 1952.

(5) If a husband and wife making a joint return for any taxable year made a joint return for one or more but not all of the taxable years involved in the computation of a net operating loss carry-over or net operating loss carry-back to such taxable year, such net operating loss carry-over or net operating loss carry-back to the taxable year is computed in the manner set forth in subparagraph (3) (i) and (ii) of this paragraph. Such net operating loss carry-over or net operating loss carry-back is considered a joint net operating loss carry-over or joint net operating loss carry-back to such taxable year. For example, if in examples (2) and (3) of subparagraph (4) of this paragraph a joint return was filed for 1953, the same amounts computed in those examples as carry-overs of H and W to that year would be the amounts considered joint net operating loss carry-overs to that year.

(6) The joint net operating loss carry-overs and the joint net operating loss carry-back to any taxable year for which a joint return is made are all the net operating loss carry-overs and net operating loss carry-backs of both spouses to such taxable year. For example, a husband and wife file a joint return for the calendar year 1953. The wife filed a separate return for the calendar years 1951 and 1952, in which years she sustained net operating losses. The husband filed separate returns for his fiscal year ending June 30, 1952, and, having received permission to change his accounting period to a calendar year basis, for the 6-month period ending December 31, 1952. The husband sustained net operating losses in both such taxable periods. Since the husband and wife did not file a joint return for any taxable year involved in the computation of the net operating loss carry-overs to 1953 from 1951 and 1952 (see paragraphs (a) to (d) inclusive, of this section) the joint net operating loss carry-overs to 1953 are the separate net operating loss carry-overs of the wife from the calendar years 1951 and 1952 and the separate net operating loss carry-overs of the husband from the fiscal year ending June 30, 1952, and from the short taxable year ending December 31, 1952. If the husband and wife also filed joint returns for the calendar years 1954 and 1955, having a joint net income in 1954 and a joint net operating loss in 1955, the joint net operating loss carry-back to 1954 from 1955 is computed upon the basis of the joint net operating loss for 1955, since separate returns were not made for any taxable year involved in the computation of such carry-back.

§ 39.122-5 *Conversion of net operating loss carry-back and net operating loss carry-overs into net operating loss deduticon.* (a) The net operating loss deduction for any taxable year is the aggregate of the net operating loss carry-overs and carry-back to such taxable year computed as prescribed in § 39.122-4, reduced by the excess of the net income for such taxable year (computed in the same manner as the net income is computed for the purposes of § 39.122-4 except that no net operating loss deduction shall be taken into account) over—

(1) In the case of a taxpayer other than a corporation, the net income computed without regard to the exceptions, additions, and limitations specified in paragraph (a) of § 39.122-3 except that no net operating loss deduction shall be taken into account; or

(2) In the case of a corporation, the normal-tax net income computed without regard to the exceptions, additions, and limitations specified in § 39.122-2 except that no net operating loss deduction shall be taken into account and the credits provided in section 26 (h) for dividends paid by a public utility on its preferred stock and section 26 (i) in the case of a Western Hemisphere trade corporation shall not be allowed.

(b) The application of this section may be illustrated by the following example:

Example. The aggregate of the net operating loss carry-overs and the net operating loss carry-back to 1952 for the X Corporation is $55,000. Its net income for 1952, computed with the adjustments required by this section, is $450,000 and its normal-tax net income, computed without any exceptions, additions, and limitations except that no net operating loss deduction is allowed and the credits provided in section 26 (h) and section 26 (i) are not allowed, is $445,000. The net operating loss deduction available to the X Corporation for the year 1952 is $50,000, computed as follows:

Aggregate of the net operating loss carry-overs and the net operating loss carry-back to 1952	$55,000
Less: Excess of net income for 1952, with adjustments, over normal-tax net income for 1952, without adjustments except that no net operating loss deduction shall be allowed and the credits provided in section 26 (h) and section 26 (i) shall not be allowed ($450,000 minus $445,000)	5,000
Net operating loss deduction for 1952	50,000

(c) If the same facts are assumed for an individual, except that, instead of having a normal-tax net income for 1952

of $445,000, he has a net income for such year of $445,000, computed without adjustments except that no net operating loss deduction shall be allowed, his net operating loss deduction for 1952 will likewise be $50,000, computed in the same manner.

(d) In the case of a husband and wife making a joint return for any taxable year, the computation of the net operating loss deduction (as set forth in paragraph (a) of this section) is to be made upon the basis of the aggregate of the joint net operating loss carry-overs and the joint net operating loss carry-back of the spouses to such year (computed as prescribed in paragraph (e) of § 39.122-4) and the combined net income of the spouses.

§ 39.123 *Statutory provisions; commodity credit loans.*

SEC. 123. *Commodity credit loans.* (a) Amounts received as loans from the Commodity Credit Corporation shall, at the election of the taxpayer, be considered as income and shall be included in gross income for the taxable year in which received.

(b) If a taxpayer exercises the election provided for in subsection (a) for any taxable year beginning after December 31, 1938, then the method of computing income so adopted shall be adhered to with respect to all subsequent taxable years unless with the approval of the Commissioner a change to a different method is authorized.

(c) [Not applicable to taxable years beginning after December 31, 1951.]

[Sec. 123 as added by sec. 223 (a), Rev. Act 1939; amended by sec. 154 (a), Rev. Act 1942]

§ 39.123-1 *Election to include loans in income.* A taxpayer who receives a loan from the Commodity Credit Corporation may at his election, include the amount of such loan in his gross income for the taxable year in which the loan is received. If a taxpayer makes such an election, then for subsequent taxable years he shall include in his gross income all amounts received during those years as loans from the Commodity Credit Corporation, unless he secures the permission of the Commissioner to change to a different method of accounting. Application for permission to change such method of accounting 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.

§ 39.123-2 *Effect of election on adjustments for other taxable years.* (a) If a taxpayer elects or has elected under section 123 of the Internal Revenue Code or section 223 (d) of the Revenue Act of 1939, as amended, to include in his gross income the amount of a loan from the Commodity Credit Corporation for the taxable year in which it is received, then—

(1) No part of the amount realized by the Commodity Credit Corporation upon the sale or other disposition of the commodity pledged for such loan shall be recognized as income to the taxpayer, unless the taxpayer receives an amount in addition to that advanced to him as the loan, in which event such additional amount shall be included in the gross income of the taxpayer for the year in which received; and

(2) No deductible loss to the taxpayer shall be recognized on account of any deficiency realized by the Commodity Credit Corporation on such loan if the taxpayer was relieved from liability for such deficiency.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. A, a taxpayer who elected for his taxable years 1952, 1953, and 1954 to include in gross income amounts received during those years as loans from the Commodity Credit Corporation, received as loans $500 in 1952, $700 in 1953, and $900 in 1954. In 1956 all the pledged commodity was sold by the Commodity Credit Corporation for an amount $100 and $200 less than the loans with respect to the commodity pledged in 1952 and 1953, respectively, and for an amount $150 greater than the loan with respect to the commodity pledged in 1954. A, in making his return for 1956, shall include in gross income the sum of $150 if it is received during that year, but will not be allowed a deduction for the deficiencies of $100 and $200 unless he is required to satisfy such deficiencies and does satisfy them during that year.

§ 39.124 *Statutory provisions; amortization deduction.*

SEC. 124. *Amortization deduction.* [No longer applicable]

§ 39.124A (a) *Statutory provisions; amortization deduction, general rule.*

SEC. 124A. *Amortization deduction*—(a) *General rule.* Every person, at his election, shall be entitled to a deduction with respect to the amortization of the adjusted basis (for determining gain) of any emergency facility (as defined in subsection (d)), based on a period of sixty months. Such amortization deduction shall be an amount, with respect to each month of such period within the taxable year, equal to the adjusted basis of the facility at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in the period. Such adjusted basis at the end of the month shall be computed without regard to the amortization deduction for such month. The amortization deduction above provided with respect to any month shall, except to the extent provided in subsection (f) of this section, be in lieu of the deduction with respect to such facility for such month provided by section 23 (l), relating to exhaustion, wear and tear, and obsolescence. The sixty-month period shall begin as to any emergency facility, at the election of the taxpayer, with the month following the month in which the facility was completed or acquired, or with the succeeding taxable year.

[Sec. 124A (a) as added by sec. 216 (a), Rev. Act 1950]

§ 39.124A (a)-1 *Amortization deduction, general rule.* (a) A person (including an estate or trust (see section 172 and § 39.172-1) and a partnership (see section 190 and § 39.190-1)) is entitled, at his election, to a deduction with respect to the amortization of the adjusted basis (for determining gain) of an emergency facility, such amortization to be based on a period of 60 months. As to the adjusted basis of an emergency facility, see § 39.124A (e)-1. The taxpayer may, with respect to an emergency facility, elect to begin the 60-month amortization period with (1) the month following the month in which such facility was completed or acquired, or (2) the taxable year succeeding that in which such facility was completed or acquired (see § 39.124A (b)-(1)) The date on which, or the month within which, an emergency facility is completed or acquired is to be determined upon the facts in the particular case. Ordinarily, the taxpayer is in possession of all the facts and, therefore, in a position to ascertain such date. A statement of the date ascertained by the taxpayer, together with a statement of the pertinent facts relied upon, should be filed with the taxpayer's election to take amortization deductions with respect to such facility.

(b) In no event shall an amortization deduction be allowed with respect to an emergency facility for any taxable year unless such facility has been certified prior to the date of filing of the taxpayer's return for such taxable year, or, in the case of an emergency facility completed or acquired after December 31, 1949, and before September 23, 1950, unless certified on or before September 23, 1951, or the date on which the return is filed, whichever is later. See section 124A (d) (1)

(c) In general, with respect to each month of the 60-month period which falls within the taxable year, the amortization deduction is an amount equal to the adjusted basis of the facility at the end of such month divided by the number of months (including the particular month for which the deduction is computed) remaining in the 60-month period. The adjusted basis of the facility at the end of any month shall be computed without regard to the amortization deduction with respect to such facility for such month. The total amortization deduction with respect to an emergency facility for a particular taxable year is the sum of the amortization deductions allowable with respect to such facility for each month of the 60-month period which falls within such taxable year. The amortization deduction with respect to an emergency facility taken for any month is in lieu of the deduction for depreciation which would otherwise be allowable under section 23 (l) with respect to such facility for such month. See, however, § 39.124A (f)-1, relating to depreciation with respect to any amount not subject to amortization.

(d) This section may be illustrated by the following examples:

Example (1). On July 1, 1952, the X Corporation, which makes its income tax returns on the calendar year basis, begins the construction of an emergency facility which is completed on September 30, 1952, at a cost of $240,000. The certificate covers the entire construction. The X Corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with October, the month following its completion. The adjusted basis of the facility at the end of October is $240,000. The allowable amortization deduction with

respect to such facility for the taxable year 1952 is $12,000, computed as follows:

Monthly amortization deductions:	
October: $240,000 divided by 60	$4,000
November: $236,000 ($240,000 minus $4,000) divided by 59	4,000
December: $232,000 ($236,000 minus $4,000) divided by 58	4,000
Total amortization deduction for 1952	12,000

Example (2). The Y Corporation, which makes its income tax returns on the basis of a fiscal year ending November 30, purchases an emergency facility (No. 1) on July 29, 1953. On June 15, 1953, it begins the construction of an emergency facility (No. 2) which is completed on August 2, 1953. The entire acquisition and construction of such facilities are covered by the certificate. The Y Corporation elects to take amortization deductions with respect to both facilities and to begin the 60-month amortization period in each case with the month following the month of acquisition or completion. At the end of the first month of the amortization period the adjusted basis of facility No. 1 is $300,000 and the adjusted basis of facility No. 2 is $54,000. In September 1953 facility No. 1 is damaged by fire, as a result of which its adjusted basis is properly reduced by $25,370. The allowable amortization deduction with respect to such facilities for the taxable year ending November 30, 1953, is $21,410, computed as follows:

Facility No. 1

Monthly amortization deductions:	
August: $300,000 divided by 60	$5,000
September: $269,630 ($300,000 minus $5,000 and $25,370) divided by 59	4,570
October: $265,060 ($269,630 minus $4,570) divided by 58	4,570
November: $260,490 ($265,060 minus $4,570) divided by 57	4,570
Amortization deduction for 1953	18,710

Facility No. 2

Monthly amortization deductions:	
September: $54,000 divided by 60	$900
October: $53,100 divided by 59	900
November: $52,200 divided by 58	900
Amortization deduction for 1953	2,700
Total amortization deduction for 1953	21,410

Example (3). On June 15, 1952, the Z Corporation, which makes its income tax returns on the calendar year basis, completes the construction of an emergency facility at a cost of $110,000. In its income tax return for 1952, filed on March 15, 1953, the Z Corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July, the month following its completion. No certificate with respect to such facility is made until April 10, 1953, and therefore no amortization deduction with respect to such facility is allowable for any month in the taxable year 1952. The Z Corporation is entitled, however, to take a deduction for depreciation of such facility for the taxable year 1952, such deduction being assumed, for the purposes of this example, to be $2,000. Accordingly, the adjusted basis of such facility at the end of January 1953 (without regard to the amortization deduction for such month) is $108,000 ($110,000 minus $2,000). For the taxable year 1953, the Z Corporation is, with respect to such facility, entitled to an amortization deduction of $24,000 computed as follows:

Monthly amortization deductions:	
January: $108,000 divided by 54	$2,000
February: $106,000 ($108,000 minus $2,000) divided by 53	2,000
March: $104,000 ($106,000 minus $2,000) divided by 52	2,000
For the remaining nine months (similarly computed)	18,000
Total amortization deduction for 1953	24,000

Since the Z Corporation elected in its return for 1952 to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1952, it must compute its amortization deductions for the 12 months in the taxable year 1953 on the basis of the remaining months of the established 60-month amortization period, as indicated in the above computation.

§ 39.124A (b) *Statutory provisions; amortization deduction; election.*

SEC. 124A. *Amortization deduction.* * * *

(b) *Election of amortization.* The election of the taxpayer to take the amortization deduction and to begin the sixty-month period with the month following the month in which the facility was completed or acquired, or with the taxable year succeeding the taxable year in which such facility was completed or acquired, shall be made by filing with the Secretary, in such manner, in such form, and within such time, as the Secretary may by regulations prescribe, a statement of such election.

[Sec. 124A (b) as added by sec. 216 (a), Rev. Act 1950]

§ 39.124A (b)-1 *Election of amortization—*(a) *General rule.* An election by the taxpayer to take amortization deductions with respect to an emergency facility and to begin the 60-month amortization period either with the month following the month in which such facility was completed or acquired, or with the taxable year succeeding the taxable year in which such facility was completed or acquired, shall be made by a statement to that effect in its return for the taxable year in which falls the first month of the 60-month amortization period so elected.

(b) *Election not made in prescribed manner* If the statement of election is not made by the taxpayer as prescribed in paragraph (a) of this section, it may, in the discretion of the Commissioner and for good cause shown, be made in such manner and form and within such time as may be approved by the Commissioner.

(c) *Other requirements and considerations.* No method of making such election other than those prescribed in this section and § 29.124A-4 of Regulations 111 (26 CFR, 1949 ed., Supps.) is permitted. Any statement of election should contain a description clearly identifying each emergency facility for which an amortization deduction is claimed. A taxpayer which does not elect, in the manner prescribed in this section or § 29.124A-4 of Regulations 111 (26 CFR, 1949 ed., Supps.), to take amortization deductions with respect to an emergency facility shall not be entitled to amortization deductions with respect to such facility. See also the last sentence of section 124A (d) (1) and paragraph (b) of § 39.124A (a)-1, restricting allowance of amortization deduction to cases where the facility has been certified prior to the date on which the return for the taxable year is filed.

§ 39.124A (c) *Statutory provisions; amortization deduction; termination.*

SEC. 124A. *Amortization deduction.* * * *

(c) *Termination of amortization deduction.* A taxpayer which has elected under subsection (b) to take the amortization deduction provided in subsection (a) may, at any time after making such election, discontinue the amortization deductions with respect to the remainder of the amortization period, such discontinuance to begin as of the beginning of any month specified by the taxpayer in a notice in writing filed with the Secretary before the beginning of such month. The deduction provided under section 23 (l) shall be allowed, beginning with the first month as to which the amortization deduction is not applicable, and the taxpayer shall not be entitled to any further amortization deductions with respect to such emergency facility.

[Sec. 124A (c) as added by sec. 216 (a), Rev. Act 1950]

§ 39.124A (c)-1 *Election to discontinue amortization.* (a) If a taxpayer has elected to take amortization deductions with respect to an emergency facility, it may, after such election and prior to the expiration of the 60-month amortization period, discontinue the amortization deductions with respect to such facility for the remainder of the 60-month period. An election to discontinue the amortization deductions shall be made by a notice in writing filed with the Commissioner of Internal Revenue, Washington 25, D. C., specifying the month as of the beginning of which the taxpayer elects to discontinue such deductions. Such notice shall be filed before the beginning of the month specified therein, and should contain a description clearly identifying the emergency facility with respect to which the taxpayer elects to discontinue the amortization deductions. If the taxpayer so elects to discontinue the amortization deductions with respect to an emergency facility, it shall not be entitled to any further amortization deductions with respect to such facility.

(b) A taxpayer which thus elects to discontinue amortization deductions with respect to an emergency facility is entitled, if such facility is depreciable property under section 23 (l) and the regulations thereunder, to a deduction for depreciation with respect to such facility. The deduction for depreciation shall begin with the first month as to which the amortization deduction is not applicable, and shall be computed on the adjusted basis of the property as of the beginning of such month (see section 113 (b) and the regulations thereunder)

(c) This section may be illustrated by the following example:

Example. On July 1, 1952, the X Corporation, which makes its income tax returns on the calendar year basis, purchases an emergency facility, consisting of land with a building thereon, at a cost of $306,000 of which $60,000 is allocable to the land and $246,000 to the building. The certificate covers the entire acquisition. The corporation elects to take amortization deductions with respect to the facility and to begin

the 60-month amortization period with the taxable year 1953. Depreciation of the building in the amount of $6,000 is deducted and allowed for the taxable year 1952. On March 25, 1954, the corporation files notice with the Commissioner of its election to discontinue the amortization deductions beginning with the month of April 1954. The adjusted basis of the facility on January 31, 1953, is $300,000, or the cost of the facility ($306,000) less the depreciation allowed for 1952 ($6,000). The amortization deductions for the taxable year 1953 and the months of January, February, and March 1954, amount to $75,000, or $5,000 per month for 15 months. Since, at the beginning of the amortization period (January 1, 1953), the adjusted basis of the land is one-fifth of the adjusted basis of the entire facility and since there are no adjustments to basis other than on account of amortization during the period, the adjusted basis of the land should be reduced by $15,000, or one-fifth of the entire amortization deduction, and the adjusted basis of the building should be reduced by $60,000, or four-fifths of the entire amortization deduction. Accordingly, the adjusted basis of the facility as of April 1, 1954, is $225,000, of which $180,000 is allocable to the building for the purpose of depreciation deductions under section 23 (l), and $45,000 is allocable to the land.

§ 39.124A (d) *Statutory provisions; amortization deduction, definitions.*

SEC. 124A. *Amortization deduction.* * * *

(d) *Definitions*—(1) *Emergency facility.* As used in this section, the term "emergency facility" means any facility, land, building, machinery, or equipment, or any part thereof, the construction, reconstruction, erection, installation, or acquisition of which was completed after December 31, 1949, and with respect to which a certificate under subsection (e) has been made. In no event shall an amortization deduction be allowed in respect of any emergency facility for any taxable year unless a certificate in respect thereof under this paragraph shall have been made prior to the filing of the taxpayer's return for such taxable year, or, in the case of an emergency facility completed or acquired by a taxpayer after December 31, 1949, and before the date of enactment of the Revenue Act of 1950, unless a certificate in respect thereof under this paragraph shall have been made prior to the expiration of twelve months after the date of enactment of the Revenue Act of 1950.

(2) *Emergency period.* As used in this section, the term "emergency period" means the period beginning January 1, 1950, and ending on the date on which the President proclaims that the utilization of a substantial portion of the emergency facilities with respect to which certifications under subsection (e) have been made is no longer required in the interest of national defense.

[Sec. 124A (d) as added by sec. 216 (a), Rev. Act 1950]

§ 39.124A (d)-1 *Definitions.* As used in §§ 39.124A (a)-1 to 39.124A (h)-1, inclusive, the term—

(a) "Certifying authority" means the certifying authority designated by the President by Executive order.

(b) "Emergency facility" means any facility, land, building, machinery, or equipment, or any part thereof, the acquisition of which occurred after December 31, 1949, or the construction, reconstruction, erection, or installation of which was completed after such date, and with respect to which a certificate under section 124A (e) has been made. In the case of an application for a certificate under section 124A (e) which is filed after March 23, 1951, only the part of any such facility which is constructed, reconstructed, erected, or installed by any person not earlier than six months prior to the filing of such application, and which is certified in accordance with section 124A (e) shall be deemed to be an emergency facility notwithstanding that the other part of such facility was constructed, reconstructed, erected, or installed earlier than six months prior to the filing of such application. The term "emergency facility" as so defined, may include, among other things, improvements of land, such as the construction of roads, bridges, and airstrips, and the dredging of channels.

(c) "Emergency period" means the period beginning on January 1, 1950, and ending on the date on which the President proclaims that the utilization of a substantial portion of the certified emergency facilities is no longer required in the interest of national defense.

§ 39.124A (e) *Statutory provisions; amortization deduction, adjusted basis of emergency facility.*

SEC. 124A. *Amortization deduction.* * * *

(e) *Determination of adjusted basis of emergency facility.* In determining, for the purposes of subsection (a) or subsection (g), the adjusted basis of an emergency facility—

(1) There shall be included only so much of the amount of the adjusted basis of such facility (computed without regard to this section) as is properly attributable to such construction, reconstruction, erection, installation, or acquisition after December 31, 1949, as the certifying authority, designated by the President by Executive order, has certified as necessary in the interest of national defense during the emergency period, and only such portion of such amount as such authority has certified as attributable to defense purposes. Such certifications shall be under such regulations as may be prescribed from time to time by such certifying authority with the approval of the President. An application for a certificate must be filed at such time and in such manner as may be prescribed by such certifying authority under such regulations but in no event shall such certificate have any effect unless an application therefor is filed before the expiration of six months after the beginning of such construction, reconstruction, erection, or installation or the date of such acquisition, or before the expiration of six months after the date of enactment of the Revenue Act of 1950, whichever is later.

(2) After the completion or acquisition of any emergency facility with respect to which a certificate under paragraph (1) has been made, any expenditure (attributable to such facility and to the period after such completion or acquisition) which does not represent construction, reconstruction, erection, installation, or acquisition, included in such certificate, but with respect to which a separate certificate is made under paragraph (1), shall not be applied in adjustment of the basis of such facility but a separate basis shall be computed therefor pursuant to paragraph (1) as if it were a new and separate emergency facility.

[Sec. 124A (e) as added by sec. 216 (a), Rev. Act 1950]

§ 39.124A (e)-1 *Adjusted basis of emergency facility*—(a) *In general.* (1) The adjusted basis of an emergency facility for the purpose of computing the amortization deduction may differ from what would otherwise constitute the adjusted basis of such emergency facility, in that it shall be the adjusted basis for determining gain (see section 113) and in that it may be only a portion of what would otherwise constitute the adjusted basis. It will be only a portion of such other adjusted basis if only a portion of the basis (unadjusted) is attributable to certified construction, reconstruction, erection, installation, or acquisition taking place after December 31, 1949. Also, it will be only a portion of what would otherwise constitute the adjusted basis of the emergency facility if only a portion of the basis (unadjusted) is certified as attributable to defense purposes. It is therefore necessary first to determine the unadjusted basis of the emergency facility from which the adjusted basis for amortization purposes is derived.

(2) The unadjusted basis for amortization purposes is the same as the unadjusted basis otherwise determined only when the entire construction, reconstruction, erection, installation, or acquisition takes place after December 31, 1949, and is certified in its entirety by the certifying authority.

(3) In cases in which only a portion of the construction, reconstruction, erection, installation, or acquisition attributable to the facility takes place after December 31, 1949, and that portion is certified in its entirety by the certifying authority, the unadjusted basis for the purpose of amortization is so much of the entire unadjusted basis as is attributable to the certified construction, reconstruction, erection, installation, or acquisition which takes place after December 31, 1949. For example, the X Corporation begins the construction of a facility on November 15, 1949, and such facility is completed on April 1, 1952, at a cost of $5,000,000 of which $4,600,000 is attributable to construction after December 31, 1949. The entire construction after December 31, 1949, is certified by the certifying authority. The unadjusted basis of the emergency facility for amortization purposes is therefore $4,600,000. For depreciation of the remaining portion of the cost ($400,000) see § 39.124A (f)-1.

(4) If the certifying authority certifies only a portion of the construction, reconstruction, erection, installation, or acquisition of property which takes place after December 31, 1949, the unadjusted basis for amortization purposes is limited to such portion so certified. Assuming the same facts as in the example in subparagraph (3) of this paragraph, except that only 50 percent of the construction, reconstruction, erection, installation, or acquisition after December 31, 1949, is certified, the unadjusted basis for amortization purposes is 50 percent of $4,600,000, or $2,300,000.

(5) The adjusted basis of an emergency facility for amortization purposes is the unadjusted basis for amortization purposes less the adjustments properly applicable thereto. Such adjustments are those specified in section 113 (b), except that no adjustments are to be taken into account which increase the adjusted basis. (See paragraph (b) of

this section.) If the taxpayer constructs, reconstructs, erects, installs, or acquires an emergency facility pursuant to a cost reimbursement contract with an obligation for reimbursement by the United States of all or a part of the cost of such facility, the unadjusted basis of such facility for amortization purposes shall not include that part of the cost for which the taxpayer is entitled to reimbursement, and the amount received as reimbursement shall be treated as a capital receipt. However, amounts received by a taxpayer which represent in fact compensation by reason of termination of a government contract or payment for articles under such a contract, though denominated reimbursements for all or a part of the cost of an emergency facility, are not to be treated as capital receipts but are to be taken into account in computing income, and are therefore not to be applied in reduction of the basis of such facility.

(6) The following examples will illustrate the computation of the adjusted basis of an emergency facility for amortization purposes:

Example (1). The X Corporation completes an emergency facility on July 1, 1952, the entire unadjusted basis of which is $500,000, and the unadjusted basis of which for the purpose of amortization is $300,000. The X Corporation elects to begin amortization as of January 1, 1953. The only adjustment to basis for the period July 1, 1952 to January 31, 1953, other than depreciation or amortization for January 1953, is $5,000 for depreciation for the last six months of 1952. The adjusted basis for the purpose of amortization is therefore $300,000 less $3,000 (300,000/500,000 X $5,000), or $297,000.

Example (2). On July 31, 1956, the Y Corporation has an emergency facility (a building) which was completed on July 1, 1952, the entire basis of which is $500,000, and the unadjusted basis of which for the purpose of amortization is $300,000. The corporation elected to begin amortization as of January 1, 1953, at which time it was entitled to $5,000 depreciation for the last six months of 1952. On July 1, 1956, the facility was damaged by fire, as the result of which its adjusted basis is properly reduced by $200,000. The adjusted basis of the emergency facility as of July 1956 for the purpose of amortization and depreciation, and the adjusted basis for other purposes, are $23,849.18, $49,250.82, and $73,100.00, respectively, computed as follows:

	For amortization	For depreciation	For other purposes
Unadjusted basis	$300,000.00	$200,000.00	$500,000
Less depreciation to Jan. 1, 1953	3,000.00	2,000.00	5,000
Adjusted basis Jan. 1953	297,000.00	198,000.00	495,000
Less amortization for 42 months	207,900.00		207,900
Less depreciation for 42 months		14,000.00	14,000
Adjusted basis at time of fire	89,100.00	184,000.00	273,100
Less fire loss (apportioned as explained below)	65,250.82	134,749.18	200,000
Adjusted basis after fire loss	23,849.18	49,250.82	73,100

The $200,000 fire loss is applied against the adjusted basis for the purpose of amortization and the adjusted basis for the purpose of depreciation in the proportion that each such adjusted basis at the time of the fire bears to their sum, i. e., 89,100/273,100 × $200,000 or $65,250.82, against the amortization basis, and 184,000/273,100 × $200,000, or $134,749.18, against the depreciation basis.

(b) *Capital additions.* (1) If, after the completion or acquisition of an emergency facility which has been certified by the certifying authority, further expenditures are made for construction, reconstruction, erection, installation, or acquisition attributable to such facility but not covered by such certification, such expenditures shall not be added to the adjusted basis of the emergency facility for amortization purposes under such certification. If such further expenditures are separately certified in accordance with the provisions of section 124A (e) (1) and this section, they are treated as certified expenditures in connection with a new and separate emergency facility and, if proper election is made, will be taken into account in computing the adjusted basis of such new and separate emergency facility for the purpose of amortization.

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

Example. On March 1, 1952, the certifying authority certifies as an emergency facility a heating plant proposed to be constructed by the Z Corporation. Such facility is completed on July 1, 1952. The Z Corporation, on August 1, 1952, begins the installation in the plant of an additional boiler, which is not included in the certification for the plant but is certified as a new and separate emergency facility. For amortization purposes, the adjusted basis of the heating plant is determined without including the cost of the additional boiler. Such cost is taken into account in computing the adjusted basis of the new and separate emergency facility (the boiler), as to which the taxpayer has a separate election for amortization purposes and a separate amortization period.

§ 39.124A (f) *Statutory provisions; amortization deduction; depreciation.*

SEC. 124A. *Amortization deduction.* * * *

(f) *Depreciation deduction.* If the adjusted basis of the emergency facility (computed without regard to this section) is in excess of the adjusted basis computed under subsection (e), the deduction provided by section 23 (l) shall, despite the provisions of subsection (a) of this section, be allowed with respect to such emergency facility as if its adjusted basis for the purpose of such deduction were an amount equal to the amount of such excess.

[Sec. 124A (f) as added by sec. 216 (a), Rev. Act 1950]

§ 39.124A (f)-1 *Depreciation of portion of emergency facility not subject to amortization.* (a) The rule set forth in section 124A (a) (see § 39.124A (a)-1), that an amortization deduction with respect to an emergency facility is in lieu of any deduction for depreciation which would otherwise be allowable under section 23 (l) with respect to such facility, is subject to the exception provided in section 124A (f) Under this exception, if the property constituting such facility is depreciable property under section 23 (l) and the regulations thereunder and if the adjusted basis of such facility as computed under section 113 (b) for purposes other than the amortization deductions (see § 39.113 (b) (1)-1) is in excess of the adjusted basis computed under section 124A (e) for the purpose of the amortization deductions (see § 39.124A (e)-1) then the excess shall be charged off over the useful life of the facility and recovered through depreciation deductions. Thus, if the construction of an emergency facility is begun on or before December 31, 1949, and completed after such date, no amortization deductions are allowable with respect to the amount attributable to such construction on or before such date (see § 39.124A (e)-1) However, if the property constituting such facility is depreciable property under section 23 (l) and the regulations thereunder, then the depreciation deduction provided by such section and regulations is allowable with respect to the amount attributable to such construction on or before December 31, 1949.

(b) Similarly, if only a portion of the construction, reconstruction, erection, installation, or acquisition after December 31, 1949, of an emergency facility has been certified by the certifying authority, and if such facility is depreciable property under section 23 (l) and the regulations thereunder, then the depreciation deduction provided by such section and regulations is allowable with respect to the portion which has not been so certified.

(c) For illustration of the treatment of a depreciable portion of an emergency facility, see example (2) in § 39.124A (e)-1 (a) (6).

§ 39.124A (g) *Statutory provisions; amortization deduction; payment by United States of unamortized cost of facility.*

SEC. 124A. *Amortization deduction.* * * *

(g) *Payment by United States of unamortized cost of facility.* If an amount is properly includible in the gross income of the taxpayer on account of a payment with respect to an emergency facility and such payment is certified as provided in paragraph (1), then, at the election of the taxpayer in its return for the taxable year in which such amount is so includible—

(1) The amortization deduction for the month in which such amount is so includible shall (in lieu of the amount of the deduction for such month computed under subsection (a)) be equal to the amount so includible but not in excess of the adjusted basis of the emergency facility as of the end of such month (computed without regard to any amortization deduction for such month). Payments referred to in this paragraph shall be payments the amounts of which are certified, under such regulations as the President may prescribe, by the certifying authority designated by the President as compensation to the taxpayer for the unamortized cost of the emergency facility made because—

(A) A contract with the United States involving the use of the facility has been terminated by its terms or by cancellation, or

(B) The taxpayer had reasonable ground (either from provisions of a contract with the United States involving the use of the facility, or from written or oral representations made under authority of the United States) for anticipating future con-

tracts involving the use of the facility, which future contracts have not been made.

(2) In case the taxpayer is not entitled to any amortization deduction with respect to the emergency facility, the deduction allowable under section 23 (l) on account of the month in which such amount is so includible shall be increased by such amount, but such deduction on account of such month shall not be in excess of the adjusted basis of the emergency facility as of the end of such month (computed without regard to any amount allowable, on account of such month, under section 23 (l) or this paragraph).

[Sec. 124A (g) as added by sec. 216 (a), Rev. Act 1950]

§ 39.124A (g)-1 *Payment by United States of unamortized cost of facility.* (a) Section 124A (g) contemplates that certain payments may be made by the United States to a taxpayer as compensation for the unamortized cost of an emergency facility. If any such payment is properly includible in gross income and has been certified, as provided in section 124A (g) as having been paid under the circumstances described therein, a taxpayer which is recovering the adjusted basis of an emergency facility through amortization rather than depreciation may elect to take an amount equal to such payment as an amortization deduction with respect to such facility for the month in which such payment is so includible. Such amortization deduction shall be in lieu of the amortization deduction otherwise allowable with respect to such facility for such month, but it shall not in any case exceed the adjusted basis of such facility (see § 39.124A (e)-1) as of the end of such month (computed without regard to any amortization deduction for such month) The election referred to in this paragraph shall be made in the return for the taxable year in which the amount of such payment is includible in gross income.

(b) If a taxpayer is recovering the adjusted basis of an emergency facility through depreciation rather than amortization, the depreciation deduction allowable under section 23 (l) for the month in which the amount of any such payment is includible in gross income shall, at the taxpayer's election, be increased by such amount; but the total deduction with respect to the certified portion of such facility shall not in any case exceed the adjusted basis of such facility (computed as provided in section 124A (e) and § 39.124A (e)-1 for amortization purposes) as of the end of such month (computed without regard to any amount allowable for such month under section 23 (l) or 124A (g) (2)) The election referred to in this paragraph shall be made in the return for the taxable year in which the amount of such payment is includible in gross income.

(c) This section may be illustrated by the following examples:

Example (1). On January 31, 1952, the X Corporation purchases an emergency facility at a cost of $600,000. The certificate covers the entire acquisition. The X Corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with February 1952, the month following the month of acquisition. On July 15, 1953, as a result of the cancellation of certain contracts with the X Corporation, the United States makes a payment of $300,000 to the corporation as compensation for the unamortized cost of such facility. The $300,000 payment is includible in the X Corporation's gross income for July 1953. The adjusted basis of such facility for amortization purposes as of the end of July 1953, computed without regard to any amortization deduction for such month, is $430,000. Accordingly, the corporation is entitled to take an amortization deduction of $300,000 for such month, in lieu of the $10,000 amortization deduction which is otherwise allowable.

Example (2). On November 30, 1952, the Y Corporation purchases an emergency facility, consisting of land with a building thereon, at a cost of $500,000, of which $200,000 is allocable to the land and $300,000 to the building. The certificate covers the entire acquisition. The Y Corporation does not elect to take amortization deductions with respect to such facility, but is entitled to a depreciation deduction with respect to the building at the rate of 3 percent per annum, or $750 per month. On August 12, 1954, as a result of cancellation of certain contracts, the United States makes a payment of $400,000 to the corporation as compensation for the unrecovered cost of such facility. The $400,000 is includible in the Y Corporation's gross income for August 1954. The adjusted basis of the facility as of the end of August 1954, computed without regard to depreciation for such month, is $485,000, of which amount $200,000 is allocable to the land and $285,000 to the building. Accordingly, the corporation is entitled to increase the $750 depreciation deduction for August 1954 by the full amount of the $400,000 payment.

§ 39.124A (h) *Statutory provisions; amortization deduction, life tenant and remainderman.*

SEC. 124A. *Amortization deduction.* * * * (h) *Life tenant and remainderman.* 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 allowable to the life tenant.

[Sec. 124A (h) as added by sec. 216 (a), Rev. Act 1950]

§ 39.124A (h)-1 *Life tenant and remainderman.* In the case of an emergency facility held by one person for life with remainder to another person, the amortization deduction shall be computed as if the life tenant were the absolute owner of the facility and shall be allowable to the life tenant during his life.

§ 39.124A (i) *Statutory provisions; amortization deduction, cross reference.*

SEC. 124A. *Amortization deduction.* * * * (i) *Cross reference.* For special rule with respect to gain derived from the sale or exchange of property the adjusted basis of which is determined with regard to this section, see section 117 (g) (3).

[Sec. 124A (i) as added by sec. 216 (a), Rev. Act 1950]

§ 39.124A (i)-1 *Cross reference.* For income tax treatment of gain from the sale or exchange of an emergency facility for which an amortization deduction has been taken, see section 117 (g) (3) and § 39.117 (g)-2.

§ 39.125 (a) *Statutory provisions; amortizable bond premium, general rule.*

SEC. 125. *Amortizable bond premium*—(a) *General rule.* In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941.

(1) *Interest wholly or partially taxable.* In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) *Interest wholly tax-exempt.* In the case of any bond the interest on which is excludible from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) *Adjustment of credit in case of interest partially tax-exempt.* In the case of any bond the interest on which is allowable as a credit against net income, the credit provided in section 25 (a) (1) or (2), or section 26 (a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year.

For adjustment to basis on account of amortizable bond premium, see section 113 (b) (1) (H).

[Sec. 125 (a) as added by sec. 126 (b), Rev. Act 1942]

§ 39.125 (a)-1 *In general*—(a) *Application.* (1) Section 125 makes provision for the amortization of bond premium by the owners of the bonds.

(i) It is mandatory with respect to—

(*a*) Fully tax-exempt bonds (the interest on which is excludible from gross income) whether the owner is a corporation, individual, or other taxpayer; and

(*b*) Partially tax-exempt bonds (the interest on which is subject only to surtax) owned by a corporation.

(ii) It is optional, at the election of the taxpayer, with respect to—

(*a*) Fully taxable bonds (the interest on which is subject to normal tax and surtax) whether the owner is a corporation, individual, or other taxpayer; and

(*b*) Partially tax-exempt bonds owned by taxpayers other than corporations

(2) As used in section 125, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof) with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation 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 any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Since bonds owned by dealers in securities are excluded from the foregoing definition, section 125 has no application to such dealers. See, however, § 39.22 (o)-1.

(b) *Operation.* (1) In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or

adjusted basis of the bonds. Thus, if such premium is $1, the basis or adjusted basis of the bond is reduced by $1. No deduction is allowable on account of such amortizable bond premium. In the case of a fully taxable bond to which section 125 is applicable, the amortizable bond premium is both an adjustment to the basis or adjusted basis of the bond and a deduction.

(2) In the case of a partially tax-exempt bond to which such section is applicable, the amortizable bond premium for the taxable year is used for three purposes: (i) As an adjustment to the basis or adjusted basis of the bond; (ii) as a deduction; and (iii) as a reduction of the credit for the interest on the bond, provided in section 25 (a) (1) or (2) or section 26 (a) Accordingly, if the interest on such a partially tax-exempt bond for the taxable year is $30 and the amortizable bond premium thereon for such taxable year is $5, the $30 is included in gross income, the $5 is allowable as a deduction, an adjustment in the amount of $5 is made to the basis or adjusted basis of the bond, and the credit on account of such interest is $25 ($30 minus $5) In the case of a taxpayer whose tax is computed under Supplement T (section 400) or who elects to take the standard deduction (section 23 (aa)) and thus no specific deduction is permitted under section 125 (a) (1) for amortization of bond premiums as such, it shall be deemed, if the taxpayer has elected to amortize bond premium in accordance with the provisions of section 125, that the deduction for amortization of amortized bond premium has been allowed for the purpose of determining the adjusted basis of the bond.

(3) In the case of a trust the income of which is distributable to the beneficiaries in whole or in part, where the trustee elects to amortize bond premium by deducting the amount thereof in the return filed for the trust on Form 1041, the distributable income of the trust determined in accordance with the provisions of section 162 (b) is the full amount otherwise distributable without reduction for amortization of bond premium in all cases where, under the law applicable to the trust or under the provisions of the trust instrument, the income distributable to the beneficiaries shall not be reduced by such reduction for amortization. See section 24 (d).

§ 39.125 (a)-2 *Bonds owned by decedents*—(a) *Cash basis decedents.* (1) If a decedent on the cash receipts and disbursements basis owned fully taxable bonds and partially tax-exempt bonds to which section 125 applies—

(i) In the case of a fully taxable bond—

(*a*) The interest accruing thereon during the period ending with his death is, by reason of section 126, included upon its receipt in the gross income of the estate or legatee, whichever acquires the right to receive such interest, while

(*b*) The deduction on account of amortizable bond premium for such period is properly allowable as a deduction for such period under the decedent's method of accounting and is not allowable as a deduction for the estate or legatee; and

(ii) In the case of a partially tax-exempt bond—

(*a*) The interest accruing thereon for such period is similarly included upon its receipt in the gross income of the estate or legatee, as the case may be;

(*b*) The estate's or legatee's credit for such interest is not reduced on account of the amortizable bond premium for such period; and

(*c*) The deduction on account of the amortizable bond premium for such period is allowable as a deduction in the return for the decedent as in the case of a fully taxable bond.

(2) The application of the provisions of subparagraph (1) of this paragraph relating to a partially tax-exempt bond may be illustrated by the following example:

Example. At the time of his death in 1952, D owns a partially tax-exempt bond to which section 125 applies. For the period beginning January 1, 1952, and ending with his death, the accrued interest on such bond is $25 and the amortizable bond premium is $2. D's estate has the right to receive such interest. D's executor, in making the income tax return for such period, may take into account a deduction in the amount of $2 on account of the amortizable bond premium for such period. D's estate includes the interest ($25) in its gross income upon receipt and, for the purposes of the normal tax, receives a credit for $25, which is not reduced on account of the amortizable bond premium which was a deduction allowable for the last taxable period of the decedent.

(b) *Accrual basis decedents.* If a decedent on the accrual basis owns fully taxable bonds and partially tax-exempt bonds to which section 125 applies—

(1) In the case of a fully taxable bond, both the interest accruing thereon during the period ending with his death and the deduction on account of the amortizable bond premium for such period remain with the decedent; and

(2) In the case of a partially tax-exempt bond, the rule as to the accrued interest and the amortization deduction is the same as in subparagraph (1) of this paragraph, and his credit for such interest is required to be reduced by the amount of the amortizable bond premium for the period ending with the decedent's death.

§ 39.125 (b) *Statutory provisions; amortizable bond premium, amount.*

SEC. 125. *Amortizable bond premium.* * * * (b) *Amortizable bond premium*—(1) *Amount of bond premium.* For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond. In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

(2) *Amount amortizable.* The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.* The determinations required under paragraphs (1) and (2) shall be made—

(A) In accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) In all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

[Subsec. (b) as added by sec. 126 (b), Rev. Act 1942, and amended by sec. 217 (a), Rev. Act 1950]

§ 39.125 (b)-1 *Bond premium and amortizable bond premium.* (a) Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. For determination of applicable call date see § 39.125 (b)-2. If the date as of which such basis of the bond was established precedes the first taxable year with respect to which section 125 applies to the bond, there shall be made adjustments proper to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 117 (h)) before the date as of which section 125 first becomes applicable to the bond in the hands of the taxpayer.

(b) The application of the rule relating to adjustments set forth in paragraph (a) of this section may be illustrated by the following examples:

Example (1). On January 1, 1952, T, who makes his income tax returns on the calendar year basis, owns a fully taxable $100 bond, maturing on January 1, 1962. T purchased this bond on January 1, 1942, for $120. T elects to have section 125 apply to such bond for 1952 and subsequent taxable years. In determining the amount of bond premium to be amortized over the remaining 10 years of the life of the bond, T is required, but solely for such purpose, to treat the bond as if he had amortized the bond premium thereon during the prior 10 years under this section, and to make the proper adjustment in the original bond premium. Accordingly, T would treat $10 as having been amortized during the first 10 years and would be required to amortize the remaining $10 over the following 10 years. When the bond is redeemed on January 1, 1962, for $100, only the $10 attributable to the second 10 years will actually have been amortized. The $10 attributable to the first 10 years will have been treated as an adjustment to the original bond premium but will not have been amortized. Consequently T will have a capital loss in the year of redemption on account of the $10 attributable to the period January 1, 1942, to January 1, 1952.

Example (2). On January 1, 1952, X's father gave him a fully taxable $100 bond maturing on January 1, 1962. X's father had purchased the bond on January 1, 1942, for $120. The fair market value of the bond at the time of the gift was $130. X makes his income tax returns on the calendar year basis and elects to amortize the bond premium on the bond during the period 1952-1962. Under section 113 (a) (2) the cost of the bond to X's father constitutes the basis of the bond in X's hands for determining loss, since such

cost is lower than the fair market value of the bond at the time of the gift, and under section 117 (h) (2) X's holding period is deemed to include the 10 years during which his father held the bond. X is required to treat the bond as if the bond premium thereon had been amortized during his father's holding period. Thus, X is required to amortize $10 over the period January 1, 1952, to January 1, 1962, and in the year of redemption will have a capital loss on account of the $10 attributable to his father's holding period.

Example (3). Y, who makes his income tax returns on the calendar year basis, owns a tax-exempt $100 bond, maturing on January 1, 1961. He purchased this bond on January 1, 1941, for $120. On December 31, 1954, Y sells the bond for $108 and thus realizes a gain of $1, computed as follows:

(1) Total bond premium ($120—$100)	$20
(2) Amount of bond premium amortizable if held to maturity (total bond premium minus unamortized bond premium attributable to 1941, $20—$1)	19
(3) Amount of bond premium amortized from Jan. 1, 1942 through Dec. 31, 1954 ($1 for each such year)	13
(4) Adjusted basis of bond at close of 1954 ($120—$13)	107
(5) Gain ($108—$107)	1

(c) Amortizable bond premium on any bond to which section 125 applies is such part of the bond premium on the bond as is attributable to the taxable year.

§ 39.125 (b)-2 *Callable and convertible bonds.* (a) The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium.

(b) A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof. However, for the purpose of determining the amount of amortizable bond premium on a convertible bond for the taxable year, the amount of bond premium shall not include any amount attributable to the conversion features of the bond. For the purpose of this rule, the term "convertible bond" includes a bond issued with detachable stock-purchase warrants.

(c) (1) The value of the conversion features of a particular bond shall be determined by ascertaining the assumed price at which such bond would be purchased on the open market if without conversion features, and by subtracting such assumed price from the cost of the bond. The determination of the assumed price of the bond without the conversion features shall be made by ascertaining the yield on which bonds of similar character, not having conversion features, are sold on the open market and adjusting the price of the bond in question to this yield. This adjustment may be made by the use of standard bond tables. In selecting quotations for comparative purposes, bonds of the same classification and grade shall be used.

(2) The application of the principles set forth in this paragraph may be illustrated as follows:

Example. T purchased for $115 a $100 bond, maturing in five years, on which interest is payable semiannually at the rate of 3.5 percent a year. This bond is convertible into common stock at the option of the holder. It is found that bonds of the same character, not having conversion features, were sold on the open market on or about the time of T's purchase on a basis to yield 2.80 percent. By recourse to a standard bond table, it is found that the cost of a 3½ percent 5-year $100 bond to yield 2.80 percent would have been $103.25. Since the taxpayer paid $115 for the convertible bond, the difference between $115 and $103.25, or $11.75, represents the value of the conversion features of the bond at the time of the purchase. The balance of $3.25 represents the bond premium subject to amortization under section 125.

(d) If a convertible bond acquired on or before June 15, 1950, is held during the taxable year, the amortizable bond premium shall be computed as if the provisions for the determination of the bond premium without the inclusion of any amount attributable to the conversion features of the bond were applicable for each year for which the bond was held prior to such taxable year. Thus, if T, in the example in paragraph (c) (2) of this section, had acquired the bond on January 1, 1949, and if T makes his income tax returns on the basis of the calendar year, the amortizable bond premium for 1952 would be $0.65, determined as follows:

Bond premium not attributable to conversion feature	$3.25
Amortizable bond premium for 1949 and 1950, determined by reference to bond premium not attributable to conversion feature	1.30
Portion of bond premium amortizable over remaining life of bond	1.95
Amortizable bond premium for each of the remaining 3 years, including the taxable year 1952 (one-third of $1.95)	65

§ 39.125 (b)-3 *Capitalized expenses.* (a) In the case of a bond on which there is no bond premium exclusive of capitalized expenses (such as buying commissions) but to which section 125 otherwise applies, a taxpayer who is required by the regulations under section 125 to use the method of amortization prescribed by § 39.125 (b)-5, a taxpayer who regularly employs a reasonable method of amortization under which such capitalized expenses are amortized, or a taxpayer who regularly employs a reasonable method of amortization under which such capitalized expenses are not amortized, is permitted, but is not required, to amortize such capitalized expenses in accordance with such method.

(b) In the case of a bond to which section 125 applies and on which there is bond premium exclusive of capitalized expenses, a taxpayer who is required by the regulations under section 125 to use the method of amortization prescribed by § 39.125 (b)-5, must treat capitalized expenses as being part of the bond premium for the purposes of section 125, or if the taxpayer regularly employs a reasonable method of amortization under which such capitalized expenses are treated as being part of the bond premium for the purposes of amortization, such capitalized expenses must be treated as being part of the bond premium for the purposes of section 125; but if under such regularly employed method such capitalized expenses are not treated as being part of the bond premium for the purposes of amortization, the taxpayer is permitted, but is not required, to treat such capitalized expenses as being part of the bond premium for the purposes of section 125.

§ 39.125 (b)-4 *Taxable years in which interest not received or accruable.* In the case of a taxpayer who makes his income returns on the cash receipts and disbursements basis or one who makes his returns on the accrual basis and who owns a bond to which section 125 applies and in respect of which no interest is received or accrued by the taxpayer during the taxable year, if the taxpayer is required by the regulations under section 125 to use the method of amortization prescribed by § 39.125 (b)-5, or if the taxpayer regularly employs a reasonable method of amortization under which the bond premium on such bond for such taxable year is amortized, or if the taxpayer regularly employs a reasonable method of amortization under which the bond premium on such bond for such taxable year is not amortized, amortization of bond premium on such bond for such taxable year is not required, but will be permitted in accordance with such method.

§ 39.125 (b)-5 *Methods of amortization.* (a) The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(1) The method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(2) The method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning before January 1, 1952, or if for taxable years beginning on or after such date a taxpayer who has

never previously taken a deduction for amortization initiates in the first taxable year for which such a deduction is taken a reasonable method of amortization and consistently follows such method thereafter. A taxpayer who regularly employs a method of amortization may be one, for example, who is subject to the jurisdiction of a State or Federal regulatory agency and who, for the purposes of such agency, amortizes the bond premium on his bonds in accordance with a method prescribed or approved by such agency. However, it is not necessary that the taxpayer be subject to the jurisdiction of such an agency or that the method be prescribed or approved by such agency. It is sufficient if the taxpayer regularly employs a method of amortization and if such method is reasonable.

(b) The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with § 39.125 (b)-1 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this subparagraph, 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.

§ 39.125 (c) *Statutory provisions; amortizable bond premium, election with respect to taxable and partially taxable bonds.*

SEC. 125. *Amortizable bond premium.* * * *

(c) *Election on taxable and partially taxable bonds*—(1) *Eligibility to elect and bonds with respect to which election permitted.* This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

(A) *Partially tax-exempt.* In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 25 (a) (1) or (2) is allowable; and

(B) *Wholly taxable.* In the case of any taxpayer, bonds the interest on which is not excludible from gross income but with respect to which the credit provided in section 25 (a) (1) or (2), or section 26 (a), as the case may be, is not allowable.

(2) *Manner and effect of election.* The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such election. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the partnership only by the partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

[Subsec. (c) as added by sec. 126 (b), Rev. Act 1942]

§ 39.125 (c)-1 *Election.* In the case of a corporation, the election provided in section 125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. In the case of bonds owned by a partnership, common trust fund, or foreign personal holding company, the election shall be exercisable by such partnership, common trust fund, or foreign personal holding company.

§ 39.125 (c)-2 *Partially tax-exempt bonds owned by estates, trusts, partnerships, etc.* If a trust owning partially tax-exempt bonds elects to amortize the bond premium thereon under section 125, the credits of the trust and the beneficiaries on account of such interest are required to be reduced by the portion of the amortization deduction attributable to their shares of such interest. A similar rule is applied in the case of partially tax-exempt bonds owned by estates, common trust funds, partnerships, foreign personal holding companies, and personal service corporations.

§ 39.125 (d)-(e) *Statutory provisions; amortizable bond premium, definition of bond; dealers in tax exempt securities; cross reference.*

SEC. 125. *Amortizable bond premium.* * * *

(d) *Definition of bond.* As used in this section, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation 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 any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

[Subsec. (d) as added by sec. 126 (b), Rev. Act 1942]

(e) *Dealers in tax-exempt securities.* For special rules applicable, in the case of dealers in securities, with respect to premium attributable to certain wholly tax-exempt securities, see section 22 (o).

[Subsec. (e) as added by sec. 203 (b) (2), Rev. Act 1950]

§ 39.126 (a) *Statutory provisions; income in respect of decedents; gross income inclusions.*

SEC. 126. *Income in respect of decedents.* (a) *Inclusion in gross income*—(1) *General rule.* The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period shall be included in the gross income, for the taxable year when received, of:

(A) The estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(B) The person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(C) The person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

(2) *Income in case of sale, etc.* If a right, described in paragraph (1), to receive an amount is transferred by the estate of the decedent or a person who receives such right by reason of the death of the decedent or by bequest, devise or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value. For the purposes of this paragraph, the term "transfer" includes sale, exchange, or other disposition, but does not include a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

(3) *Character of income determined by reference to decedent.* The right, described in paragraph (1), to receive an amount shall be treated, in the hands of the estate of the decedent or any person who acquired such right by reason of the death of the decedent, or by bequest, devise, or inheritance from the decedent, as if it had been acquired by the estate or such person in the transaction by which the decedent acquired such right; and the amount includible in gross income under paragraph (1) or (2) shall be considered in the hands of the estate or such person to have the character which it would have had

in the hands of the decedent if the decedent had lived and received such amount.

[Sec. 126 (a) as added by sec. 134 (e), Rev. Act 1942]

§ 39.126 (a)-1 *Inclusion in gross income of income in respect of a decedent.* (a) The gross income for the taxable year of a decedent in which falls the date of his death is computed upon the basis of the method of accounting followed by such decedent even though amounts to which he is entitled as gross income are not includible under such method in computing net income for such taxable year or any prior taxable year. See § 39.42-1. Such amounts include all the accrued income of a decedent who reported his income on the basis of cash receipts and disbursements, and, in the case of a decedent who reported his income under the accrual method of accounting, such amounts include contingent items which were not accrued by the decedent and, under § 39.42-1, all items (except the amount of partnership income includible under section 182) which were accrued in the last taxable year of the decedent solely by reason of his death. For example, if the decedent who reported income on the basis of the accrual method of accounting was a member of a partnership which kept its books on the basis of cash receipts and disbursements, the decedent would be entitled at the date of his death to his distributive share of the accrued income of the partnership, although there would be included in his gross income only his distributive share of the partnership income computed on the basis of cash receipts and disbursements.

(b) Under section 126 (a) (1) all such amounts to which a decedent is entitled as gross income and which are not includible in computing his net income for his last taxable year or any prior taxable year shall be included, when received, in the gross income of the estate of the decedent or of the person receiving such amounts if such amounts are received by the estate of the decedent or by a person entitled to such amounts by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent. These amounts are included in the income of the estate and such persons when received by them, regardless of whether or not they report income on the basis of cash receipts and disbursements.

(c) The persons who are placed with respect to such amounts in the same position as the decedent are the decedent's estate (which in the great majority of cases will be the one who receives such amounts) and, if the estate does not collect such amounts but distributes the right to receive such amounts to the heir, next of kin, legatee, or devisee who inherited or was bequeathed or devised such right, such heir, next of kin, legatee or devisee. Thus, if the decedent who kept his books on the basis of cash receipts and disbursements was entitled at the date of his death to a large salary payment to be made in equal annual installments over five years, and his estate after collecting two installments distributed the right to the remaining installment payments to the residuary legatee of the estate, the estate must include in its gross income the two installments received by it, and the legatee must include in his gross income each of the three installments received by him.

(d) Also placed in the same position as the decedent with respect to such amounts are those who acquire the right to such amounts by reason of the death of the decedent. An example of the application of this provision is the case of a decedent who owned a defense bond, with his wife as co-owner or beneficiary and who died before the payment of such bond. The entire amount accruing on the bond and not includible in income by the decedent, not just the amount accruing after the death of the decedent, would be treated as income to his wife when the bond is paid. Another example is the case of a partner whose partnership agreement provided that upon his death his interest in certain partnership assets would pass to the surviving partners in exchange for payments to be made by them to his widow. Upon his death, the payments by the surviving partners must be included in the widow's income to the extent they are attributable to the earnings of the partnership accrued only by reason of his death. The income reflected by the payments to the extent they are so attributable was not includible in the partner's income since it was not received by the partner (for the purposes of the cash receipts and disbursements method of accounting) and was accrued only by reason of his death (for the purposes of the accrual method of accounting) If the payments are to be made to the widow as trustee for minor children, and if the right to receive such payments is transferred to the children upon their majority, the children are within the provisions of section 126 (a) (1) as receiving the right to such payments by reason of the death of the decedent, and must include such payments when received in their income to the extent the payments are attributable to the earnings of the partnership accrued only by reason of the death.

Example. Suppose that A and the decedent B were equal partners in a business possessed of tangible assets having a present value considerably in excess of cost; suppose that certain current partnership business was well advanced toward completion before the death of B; and suppose that the partnership agreement provided that, upon the death of one of the partners, all partnership assets, including unfinished business, should pass to the surviving partner, and that the surviving partner should make certain payments to the estate of the decedent. To the extent that the payments by A to the estate of B are attributable to B's interest in the previously earned proportion of the unfinished partnership business transactions, their receipt by the estate of B will reflect the realization of income. With respect to such portion of the payments by A as is attributable to B's interest in the tangible assets of the partnership which had appreciated in value, no gain to the estate of B will be recognized. If some portion of the payments by A is attributable to a sale of B's interest in partnership assets consummated by B before his death, however, the gain to the estate of B reflected in such payments will be recognized regardless of the character of the asset sold, and regardless of whether or not payment was due on a day which must occur after B's death.

(e) Since section 126 provides for the treatment of such amounts as income to the estate and other persons placed in the same position as the decedent with respect to such amounts, the provisions of section 113 (a) (5) with respect to the basis of property acquired by bequest, devise, or inheritance do not apply to these amounts in the hands of the estate and such persons. Furthermore, section 126 only applies to the amount of items of gross income in respect of a decedent, and items which are excluded from his gross income under section 22 (b) or section 116 are not within the provisions of section 126.

(f) If the right to receive an amount of income in respect of a decedent is transferred by the estate or the person entitled to such amount by bequest, devise, or inheritance, or by reason of the death of the decedent, the fair market value of such right at the date of the transfer shall be included in the income of the estate or of such person, plus the amount by which any consideration received on such transfer exceeds the fair market value of such right. Thus, upon a sale of such right, the fair market value of the right or the amount received upon the sale, whichever is greater, is included in income. Similarly, if the right to receive the income is disposed of, as by gift or bequest, the fair market value of such right at the time of such disposition must be included in the gross income of the donor, testator, or other transferor. However, if the person to whom such right is transferred is a person described in section 126 (a) (1) as being entitled to such right by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent, such fair market value of the right is not included in the income of the transferor. Examples of such transfers are those by the estate to a specific legatee of such right or to the residuary legatee. Another example is the case of a trust to which is bequeathed the right of the decedent to certain payments of income. If the trust terminates and the right to such payments is transferred to the beneficiary, the trust does not include the fair market value of the right to receive such payments in its income, but such payments are included in the income of the beneficiary under the provisions of section 126 (a) (1) Under section 126 (a) (1) the transferee in each of the above examples must include the amount, when received, in his income, and if he transfers the right to receive such amount to a person not entitled to such right by bequest, devise, or inheritance from the decedent or by reason of his death, then he must include in his income the fair market value of the right at the time of such transfer.

(g) The right to receive an amount of income in respect of a decedent shall be treated in the hands of the estate or the person entitled to receive such amount by bequest, devise, or inheritance from the decedent or by reason of

his death as if it had been acquired in the transaction by which the decedent acquired such right, and shall be considered as having the same character it would have had if the decedent had lived and received such amount. The estate or such person is placed in the same position with respect to the nature of this income as the position the decedent enjoyed. Thus, if the income would have been capital gain to the decedent, if he had lived and had received it, from the sale of property held for more than six months, the income when received, or its fair market value if transferred, shall be treated in the hands of the estate or of such person as gain from the sale of the property, held for more than six months, in the same manner as if such person had held the property for the period the decedent held it, and had made the sale. Similarly, if the income is interest on United States obligations owned by the decedent, such income shall be treated as interest on United States obligations in the hands of the person receiving it, for the purpose of determining the credit provided by section 25 (a) (1) and (2) as if such person owned the obligations with respect to which such interest is paid. If the amount would have constituted earned income to the decedent, as in the case of the accrued wages of a decedent who reported income on the basis of cash receipts and disbursements, such amount shall constitute earned income to the person including such amount in his gross income to the same extent as if he had been engaged in place of the decedent in the transaction in which the amount was earned. If the amounts received would be subject to special treatment under section 107 if the decedent had lived and included such amounts in his gross income, section 107 applies. Similarly, the provisions of sections 105 and 106, relating to the surtax attributable to the sale of certain oil or gas property and to certain claims against the United States, apply to any amount included in gross income, the right to which was obtained by the decedent by a sale or claim within the provisions of those sections. The surtax attributable to the inclusion in the gross income of the person receiving the amount referred to in the preceding sentence shall not exceed 30 percent of such amount.

§ 39.126 (b) *Statutory provisions; income in respect of decedents; allowance of deductions and credit.*

SEC. 126. *Income in respect of decedents.* * * *

(b) *Allowance of deductions and credit.* The amount of any deduction specified in section 23 (a), (b), (c), or (m) (relating to deductions for expenses, interest, taxes, and depletion) or credit specified in section 31 (foreign tax credit), in respect of a decedent which is not properly allowable to the decedent in respect of the taxable period in which falls the date of his death, or a prior period, shall be allowed:

(1) *Expenses, interest, and taxes.* In the case of a deduction specified in section 23 (a), (b), or (c) and a credit specified in section 31, in the taxable year when paid—

(A) To the estate of the decedent; except that

(B) If the estate of the decedent is not liable to discharge the obligation to which the deduction or credit relates, to the person who, by reason of the death of the decedent or by bequest, devise, or inheritance acquires, subject to such obligation, from the decedent an interest in property of the decedent.

(2) *Depletion.* In the case of the deduction specified in section 23 (m), to the person described in subsection (a) (1) (A), (B), or (C) who, in the manner described therein, receives the income to which the deduction relates, in the taxable year when such income is received.

[Sec. 126 (b) as added by sec. 134 (e), Rev. Act 1942]

§ 39.126 (b)-1 *Allowance of deductions and credit in respect of decedent.* (a) Under section 126 (b) the expenses, interest, and taxes described in section 23 (a) (b) and (c) for which the decedent was liable, which were not properly allowable as a deduction in his last taxable year or any prior taxable year, are allowed when paid (1) as a deduction by the estate, or (2) if the estate was not liable to pay such obligation, as a deduction by the person who by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent acquires, subject to such obligation, an interest in property of the decedent. Similar treatment is given to the foreign tax credit provided by section 31. For the purposes of clause (2) of this paragraph, the right to receive an amount of gross income in respect of a decedent is considered property of the decedent; on the other hand, it is not necessary for a person, otherwise within the provisions of clause (2) of this paragraph, to receive the right to any income in respect of a decedent. Thus, if the right to income in respect of a decedent, receivable by reason of the death of the decedent by a person other than the estate, is subject to an income tax imposed during the life of the decedent by a foreign country, which tax must be satisfied out of such income, such person is entitled to the credit provided in section 31 when he pays this obligation. If the decedent, who reported income on the basis of cash receipts and disbursements, owned real property on which no income had accrued, but on which accrued taxes had become a lien, and if such property passed directly to the heir of the decedent in a jurisdiction in which real property does not become a part of a decedent's estate, the heir, upon paying such taxes, may take the same deduction under section 23 (c) that would be allowed to the decedent if, while alive, he had made such payments.

(b) The deduction for percentage depletion is allowable only to the person who receives the income in respect of the decedent to which the deduction relates, whether or not such person receives the property from which such income is derived. Thus, if the income results from payments on units of mineral sold by the decedent, who reported income on the basis of cash receipts and disbursements, the deduction for depletion, computed on such number of units as if the person receiving such income had the same economic interest as the decedent, shall be allowed to such person regardless of whether or not he receives any interest in the mineral property other than such income. If the decedent did not compute his deduction for depletion on the basis of percentage depletion, any deduction for depletion to which the decedent was entitled at the date of his death would be allowable in computing his net income for his last taxable year, and there can be no deduction in respect of the decedent by any other person for such depletion.

§ 39.126 (c) *Statutory provisions; income in respect of decedents; deduction for estate tax.*

SEC. 126. *Income in respect of decedents.* * * *

(c) *Deduction for estate tax*—(1) *Allowance of deduction.* A person who includes an amount in gross income under subsection (a) shall be allowed, for the same taxable year, as a deduction an amount which bears the same ratio to the estate tax attributable to the net value for estate tax purposes of all the items described in subsection (a) (1) as the value for estate tax purposes of the items of gross income or portions thereof in respect of which such person included the amount in gross income (or the amount included in gross income, whichever is lower) bears to the value for estate tax purposes of all the items described in subsection (a) (1).

(2) *Method of computing deduction.* For the purposes of paragraph (1)

(A) The term "estate tax" means the tax imposed upon the estate of the decedent under section 810 or 860, reduced by the credits against such tax, plus the tax imposed upon the estate of the decedent under section 935, reduced by the credits against such tax.

(B) The net value for estate tax purposes of all the items described in subsection (a) (1) shall be the excess of the value for estate tax purposes of all the items described in subsection (a) (1) over the deductions from the gross estate in respect of claims which represent the deductions and credit described in subsection (b).

(C) The estate tax attributable to such net value shall be an amount equal to the excess of the estate tax over the estate tax computed without including in the gross estate such net value.

[Sec. 126 (c) as added by sec. 134 (e), Rev. Act 1942]

§ 39.126 (c)-1 *Deduction for estate tax attributable to income in respect of decedent.* (a) Section 126 (c) provides that the estate or person required to include in gross income any amount in respect of a decedent may deduct that portion of the estate tax on the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount. This deduction is determined by first ascertaining the net value in the decedent's estate of the items which are included under section 126 in computing the income of the persons described in that section, that is, the excess of the value included in the gross estate on account of the items of gross income in respect of the decedent over the deductions from the gross estate for claims which represent the deductions and credit in respect of the decedent described in section 126 (b) The portion of the estate tax (the sum of the basic estate tax and the additional estate tax, reduced by the credits against such taxes) attributable to the inclusion in the gross estate of such net value is the excess of the estate tax over the estate

tax computed without including such net value in the gross estate. The estate and each person receiving income in respect of the decedent may deduct as his share of such portion of the estate tax an amount which bears the same ratio to such portion as the value in the gross estate of the right to the income included by the estate or such person in gross income bears to the value in the gross estate of all the items of gross income in respect of the decedent.

(b) Section 126 (c) is illustrated by the following example:

Example. X, an attorney who kept his books on the basis of the cash receipts and disbursements method of accounting, was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued in his estate at $1,000, and to accrued bond interest which was valued at $500. In all, $1,500 was included in his gross estate in respect of income described in section 126 (a) (1). There were deducted as claims against his estate $150 for business expenses for which his estate was liable, and $50 for taxes accrued on certain property he owned, in all, $200, for claims which represent the deductions described in section 126 (b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate is $185,000 and his net estate, computed without deducting any specific exemption, is $170,000, on which the total basic and additional estate tax (reduced by credits against such tax) is $23,625. In the year following the death of X, his estate collected the fee in the amount of $1,200, which amount is included in the income of the estate. The estate may deduct, in computing its net income for such year, $260 on account of the estate tax attributable to such income; computed as follows:

(1) (i) Value of income described in section 126 (a) (1) included in computing gross estate	$1,500
(ii) Deductions in computing gross estate for claims representing deductions described in section 126 (b)	200
(iii) Net value of items described in section 126 (a) (1)	1,300
(2) (i) Estate tax (basic and additional estate taxes, less credits against such taxes)	23,625
(ii) Less: Estate tax computed without including $1,300 (item (1) (iii)) in gross estate	23,235
(iii) Portion of estate tax attributable to net value of income items	390
(3) (i) Value in gross estate of income received by estate in taxable year	1,000
(ii) Value in gross estate of all income items described in section 126 (a) (1) (item (1) (i))	1,500
(iii) Part of estate tax deductible upon receiving the $1,200 fee $\left(\frac{1,000}{1,500}\text{ of } \$390\right)$	260

Although $1,200 was later collected as the fee, only the $1,000 actually included in the gross estate is used in the above computations. However, to avoid distortion, section 126 (c) provides that if the value included in the gross estate is greater than the amount finally collected, only the amount collected shall be used in the above computations. Thus, if the amount collected as the fee were only $500, the estate tax deductible on the receipt of such amount would be $\frac{500}{1,500}$ of $390, or $130.

§ 39.127 (a) *Statutory provisions; war losses; application.*

SEC. 127. *War losses*—(a) *Cases in which loss deemed sustained, and time deemed sustained.* For the purposes of this chapter—

(1) *Property not in enemy countries.* Property destroyed or seized on or after December 7, 1941, in the course of military or naval operations by the United States or any other country engaged in the present war shall be deemed to have been destroyed or seized on a date chosen by the taxpayer in the manner provided in paragraph (4), which falls between—

(A) The latest date, as established to the satisfaction of the Commissioner, on which such property may be considered as not destroyed or seized, and

(B) The earliest date, as established to the satisfaction of the Commissioner, on which such property may be considered as having already been destroyed or seized.

For the purposes of this paragraph property within an area which comes under the control of a country at war with the United States after the date war with such country is declared by the United States shall be deemed to have been destroyed or seized in the course of military or naval operations by such country, and the date specified in subparagraph (A) shall not be later than the latest date determined by the Commissioner as the date on which such area was under the control of the United States or a country not at war with the United States, and the date specified in subparagraph (B) shall not be later than the earliest date determined by the Commissioner as the date on which such area may be considered under the control of the country which is at war with the United States.

(2) *Property in enemy countries.* Property within any country at war with the United States, or within an area under the control of any such country on the date war with such country was declared by the United States, shall be deemed to have been destroyed or seized on the date war with such country was declared by the United States.

(3) *Investments referable to destroyed or seized property.* Any interest in, or with respect to, property described in paragraph (1) or (2) (including any interest represented by a security as defined in section 23 (g) (3) or section 23 (k) (3)) which becomes worthless shall be considered to have been destroyed or seized (and the loss therefrom shall be considered a loss from the destruction or seizure) on the date chosen by the taxpayer which falls between the dates specified in paragraph (1), or on the date prescribed in paragraph (2), as the case may be, when the last property (described in the applicable paragraph) to which the interest relates would be deemed destroyed or seized under the applicable paragraph. This paragraph shall apply only if the interest would have become worthless if the property had been destroyed. For the purposes of this paragraph, an interest shall be deemed to have become worthless notwithstanding the fact that such interest has a value if such value is attributable solely to the possibility of recovery of the property, compensation (other than insurance or similar indemnity) on account of its destruction or seizure, or both. Section 23 (g) (2) and (k) (2) shall not apply to any interest which under this paragraph is considered to have been destroyed or seized. Under regulations prescribed by the Commissioner with the approval of the Secretary, a taxpayer which owns 100 per centum (excluding qualifying shares) of each class of stock of a corporation may elect to determine the worthlessness of its interest, described in this paragraph, in or with respect to the property of the corporation, without regard to the amount of the property of such corporation which would be excluded under subsection (e) (2) (A) in determining the adjusted basis of all the assets of the corporation for the purposes of subsection (e), but such amount shall be treated under subsection (b) (1) as a recovery by the taxpayer in the taxable year with respect to such interest.

(4) *Choice of date.* The taxpayer's choice of a date under paragraph (1) or (3) shall be effective only if made within such time and in such manner as may be prescribed by regulations prescribed by the Commissioner with the approval of the Secretary.

[Sec. 127 (a) as added by sec. 156 (a), Rev. Act 1942]

§ 39.127 (a)-1 *War losses generally.* For regulations governing the treatment of war losses, see §§ 29.127 (a)-1 to 29.127 (a)-4, inclusive, 29.127 (b)-1, and 29.127 (e)-1 of Regulations 111 (26 CFR, 1949 ed., Supps.)

§ 39.127 (b)-(c) *Statutory provisions; war losses; amount of loss; recoveries.*

SEC. 127. *War losses.* * * *

(b) *Amount of loss on destroyed or seized property.* In the case of any property or interest in or with respect to property deemed to be destroyed or seized under subsection (a)—

(1) The amount of the loss on account of such property or interest shall be determined with regard to any recoveries with respect thereto in the taxable year but without regard to any possibility of recovering such property or interest, or of receiving any compensation (other than insurance or similar indemnity) on account of such property or interest in the taxable year or in any future taxable year.

(2) The taxpayer may choose to decrease the amount of the loss by all obligations or liabilities of the taxpayer with respect to such property or interest discharged or satisfied out of the property or interest upon its destruction or seizure, if the Commissioner is satisfied that such obligations or liabilities are so discharged or satisfied in a subsequent taxable year, or that the taxpayer is unable to determine whether or not such obligations or liabilities are in fact discharged or satisfied.

No loss shall be deemed to have been sustained upon the destruction or seizure of such property or interest to the extent that it is compensated for by the discharge or satisfaction of obligations and liabilities of the taxpayer out of such property or interest in the taxable year in which such destruction or seizure is deemed to have occurred. The taxpayer's choice under this subsection shall be effective only if made within such time and in such manner as may be prescribed by regulations prescribed by the Commissioner with the approval of the Secretary.

[Sec. 127 (b) as added by sec. 156 (a), Rev. Act 1942]

(c) *Recoveries*—(1) *General rule.* Upon the recovery in the taxable year of any money or property in respect of property considered under subsection (a) as destroyed or seized in any prior taxable year, the amount of such recovery shall be included in gross income to the extent provided in paragraph (2), unless the provisions of paragraph (3) are applicable to the taxable year pursuant to an election made by the taxpayer under the provisions of paragraph (5).

(2) *Inclusion in gross income*—(A) *Amount of recovery.* The amount of the recovery of any money or property in respect of property considered under subsection (a) as destroyed or seized in any prior taxable year shall be an amount equal to the aggregate of such money and the fair market value of such property, determined as of the date of the recovery.

(B) *Amount of gain includible.* To the extent that the amount of the recovery plus the aggregate of the amounts of previous such recoveries do not exceed that part of the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of property described in subsection (a) which did not result in a reduction of any tax of the taxpayer under this chapter or chapter 2, such amount shall not be includible in gross income and shall not be deemed gain upon the involuntary conversion of property as a result of its destruction or seizure. To the extent that such amount plus the aggregate of the amounts of previous such recoveries exceed that part of the aggregate of such deductions, which did not result in a reduction of any tax of the taxpayer under this chapter or chapter 2 and do not exceed that part of the aggregate of such deductions which did result in a reduction of any tax of the taxpayer under this chapter or chapter 2, such amount shall be included in gross income but shall not be deemed a gain upon the involuntary conversion of property as a result of its destruction or seizure. To the extent that such amount plus the aggregate of the amounts of previous such recoveries exceed the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of property described in subsection (a), such amount shall be considered a gain upon the involuntary conversion of property as a result of its destruction or seizure and shall be recognized or not recognized as provided in section 112 (f). If for any previous taxable year the taxpayer chooses under subsection (b) to treat any obligations and liabilities as discharged or satisfied out of the property or interest described in subsection (a), and if such obligations and liabilities were not so discharged or satisfied, the amount of such obligations and liabilities treated as discharged or satisfied under subsection (b) shall be considered for the purposes of this section as a deduction by reason of this section which did not result in a reduction of any tax of the taxpayer under this chapter or chapter 2. For the purposes of this paragraph an allowable deduction for any taxable year on account of the destruction or seizure of property described in subsection (a) shall, to the extent not allowed in computing the tax of the taxpayer for such taxable year, be considered an allowable deduction which did not result in a reduction of any tax for the taxpayer under this chapter or chapter 2.

(3) *Tax adjustment measured by prior benefits.* If the provisions of this paragraph are applicable to the taxable year pursuant to an election made by the taxpayer under the provisions of paragraph (5)—

(A) *Amount of recovery.* The amount of the recovery in the taxable year of any money or property in respect of property considered under subsection (a) as destroyed or seized in any prior taxable year shall be an amount equal to the aggregate of such money and the fair market value of such property, determined as of the date of the recovery. For the purpose of this paragraph, in the case of the recovery of the same property or interest considered under subsection (a) as destroyed or seized, the fair market value of such property or interest shall, at the option of the taxpayer, be considered an amount equal to the adjusted basis (for determining loss) of such property or interest in the hands of the taxpayer on the date such property or interest was considered under subsection (a) as destroyed or seized. The amount of the recovery determined under this subparagraph shall be reduced for the purposes of subparagraphs (B) and (C) by the amount of the obligations or liabilities with respect to the property considered under subsection (a) as destroyed or seized in respect of which the recovery was received, if the taxpayer for any previous taxable year chose under subsection (b) (2) to treat such obligations or liabilities as discharged or satisfied out of such property, and such obligations or liabilities were not so discharged or satisfied prior to the date of the recovery.

(B) *Adjustment for prior tax benefits.* That part of the amount of the recovery, in respect of any property considered under subsection (a) as destroyed or seized, which is not in excess of the allowable deductions in prior taxable years on account of such destruction or seizure of the property (the amount of such allowable deductions being first reduced by the aggregate amount of any prior recoveries in respect of the same property) shall be excluded from gross income for the taxable year of the recovery for the purpose of computing the tax under this chapter and chapter 2; but there shall be added to, and assessed and collected as a part of, the tax under this chapter for the taxable year of the recovery the total increase in the tax under this chapter and chapter 2 for all taxable years which would result by decreasing, in an amount equal to such part of the recovery so excluded, such deductions allowable in the prior taxable years with respect to the destruction or seizure of the property. Such increase in the tax for each such year so resulting shall be computed in accordance with regulations prescribed by the Secretary. Such regulations shall give effect to previous recoveries of any kind (including recoveries described in section 22 (b) (12)) with respect to any prior year, and shall provide for the case where there was no tax for the prior year, but shall otherwise treat the tax previously determined for any year in accordance with the principles set forth in section 3801 (d). All credits allowable against the tax for any year and all carry-overs and carry-backs affected by so decreasing the allowable deductions shall be taken into account in computing the increase in the tax, except that the computation of the excess profits credit under Chapter 2E for any taxable year shall not be affected.

(C) *Gain upon recovery.* The amount of any recovery or part thereof, in respect of property considered under subsection (a) as destroyed or seized, which is not excluded from gross income under the provisions of subparagraph (B) shall be considered for the taxable year of the recovery as gain on the involuntary conversion of property as a result of its destruction or seizure and shall be recognized or not recognized as provided in section 112 (f).

(D) *Recoveries treated as gross income for certain purposes.* For the purposes of sections 51, 52, and 3801 (b) the recovery in the taxable year of any money or property in respect of property considered under subsection (a) as destroyed or seized in any prior taxable year shall be deemed to be an item includible in gross income for the taxable year in which the recovery is made.

(4) *Restoration of value of investments referable to destroyed or seized property.* For the purpose of this subsection the restoration in whole or in part of the value of any interest described in subsection (a) (3) by reason of any recovery of money or property in respect of property to which such interest related and which was considered under subsection (a) (1) or (2) as destroyed or seized shall be deemed a recovery of property in respect of property considered under subsection (a) as destroyed or seized. In applying paragraph (3) of this subsection such restoration shall be treated as the recovery of the same interest considered under subsection (a) as destroyed or seized.

(5) *Election by taxpayer for application of paragraph (3).* If the taxpayer elects to have the provisions of paragraph (3) applicable to any taxable year in which he recovered any money or property in respect of property considered under subsection (a) as destroyed or seized, the provisions of paragraph (3) shall be applicable to all taxable years of the taxpayer beginning after December 31, 1941, and such election, once made, shall be irrevocable. The election shall be made in such manner and at such time as the Secretary may by regulations prescribe, except that no election under this paragraph may be made after December 31, 1952, unless the taxpayer recovers money or property (in respect of property considered under subsection (a) as destroyed or seized) during a taxable year ending after the date of the enactment of the Revenue Act of 1951. If pursuant to such election the provisions of paragraph (3) are applicable to any taxable year—

(A) The period of limitations provided in sections 275 and 276 on the making of assessments and the beginning of distraint or a proceeding in court for collection shall not, with respect to—

(i) The amount to be added to the tax for such taxable year under the provisions of paragraph (3), and

(ii) Any deficiency for such taxable year or for any other taxable year, to the extent attributable to the basis of the recovered property being determined under the provisions of subsection (d) (2),

expire prior to the expiration of two years following the date of the making of such election, and such amount and such deficiency may be assessed at any time prior to the expiration of such period notwithstanding any law or rule of law which would otherwise prevent such assessment and collection, and

(B) In case refund or credit of any overpayment resulting from the application of the provisions of paragraph (3) to such taxable year is prevented on the date of the making of such election, or within one year from such date, by the operation of any law or rule of law (other than section 3761, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within one year from such date.

In the case of any taxable year ending before the date of the making by the taxpayer of an election under this paragraph, no interest shall be paid on any overpayment resulting from the application of the provisions of paragraph (3) to such taxable year, and no interest shall be assessed or collected with respect to any amount or any deficiency specified in clause (A), for any period prior to the expiration of six months following the date of the making of such election by the taxpayer.

[Sec. 127 (c) as added by sec. 156 (a), Rev. Act 1942, amended by sec. 341 (a), Rev. Act 1951]

§ 39.127 (c)-1 *Recoveries in respect of war losses*—(a) *In general.* (1) Upon the recovery by the taxpayer in the taxable year of any money or property in respect of property considered under section 127 (a) as destroyed or seized in any prior taxable year, the amount of such recovery must be included in gross income to the extent provided in section 127 (c) (2) unless, pursuant to the taxpayer's election, the provisions of section 127 (c) (3) are applicable to such recovery. For the treatment of war loss

recoveries under such provisions, and the manner of making such election, see paragraphs (c) and (d) of this section.

(2) Except as provided in section 127 (c) (3) (A) and in this paragraph, the amount of the recovery in respect of a war loss in a previous taxable year is determined in the same manner for the purpose of section 127 (c) (2) or (3) The amount of the recovery of any money or property in respect of any war loss is the aggregate of the amount of such money and of the fair market value of such property both determined as of the date of the recovery If, pursuant to the taxpayer's election under section 127 (c) (5) the provisions of section 127 (c) (3) are applicable to any taxable year in which he recovers the same property or interest considered under section 127 (a) as destroyed or seized in a previous taxable year, the fair market value of such property or interest shall, at the option of the taxpayer, be considered an amount equal to the adjusted basis (for determining loss) of such property or interest in the hands of the taxpayer on the date such property or interest was considered as destroyed or seized. This option is exercisable by the taxpayer with respect to each separate property or interest considered under section 127 (a) as destroyed or seized in a previous taxable year. Also, if the provisions of section 127 (c) (3) are applicable pursuant to the taxpayer's election, the amount of the recovery of any money or property in respect of property considered under section 127 (a) as destroyed or seized in any prior taxable year shall be reduced for the purpose of section 127 (c) (3) (B) and (C) by the amount of the obligations or liabilities with respect to such property, if the taxpayer for any previous taxable year chose under section 127 (b) (2) to treat such obligations or liabilities as discharged or satisfied out of such property, and such obligations or liabilities were not so discharged or satisfied before the date of the recovery. See § 29.127 (b)-1 of Regulations 111 (26 CFR, 1949 ed., Supps.) The recoveries in respect of any war loss include the recovery of the property or interest treated as destroyed or seized under section 127 and the recovery of any money or property in lieu of such property or interest or on account of the destruction or seizure of such property or interest. For example, there is a recovery upon the return to the taxpayer after the termination of the war of his property which was treated as resulting in a war loss because it was located in a country at war with the United States.

An award by a government on account of the seizure of the taxpayer's property by an enemy country is a recovery under section 127 (c) The amount obtained upon the sale or other transfer by the taxpayer of his right to any property treated as resulting in a war loss is also a recovery for the purpose of section 127 (c) Similarly if a taxpayer who sustained a war loss under section 127 (c) upon the liquidation of a corporation has received the rights to any property of the corporation which was treated as destroyed or seized under section 127 (a) (1) or (2) any recovery by the taxpayer with respect to such rights is a recovery by him for the purposes of section 127 (c) Furthermore, if any interest of the taxpayer in or with respect to property was determined to be worthless and was treated as a war loss under section 127 (a) (3) (see § 29.127 (a)-4 of Regulations 111 (26 CFR, 1949 ed., Supps.)) or if the taxpayer retained an interest in a corporation with respect to which he sustained a war loss under section 127 (e), and if the interest in the hands of the taxpayer is restored in value, in whole or in part, by reason of a recovery with respect to the underlying assets treated as destroyed or seized under section 127, then such restoration in value is a recovery by the taxpayer for the purposes of section 127 (c) In the application of section 127 (c) (3), such restoration shall be treated as a recovery of the same interest considered as destroyed or seized. Property considered as destroyed or seized under section 127 (a) is considered as not being in existence from the date of the loss to the date of its recovery.

(3) For the purpose of section 127 (c) the recoveries considered are only those with respect to war losses sustained in prior taxable years. Similarly, the only deductions considered are those allowable for prior taxable years, and any allowable deductions for the year of the recovery are ignored for the purposes of applying such section to the recovery. If property is treated as destroyed or seized under section 127, and if in the same taxable year there is also a recovery with respect to such property, such recovery is not within the provisions of section 127 (c) but is taken into account under section 127 (b) in determining the amount of the loss, if any, on the destruction or seizure. See section 127 (b)-1. An allowable deduction with respect to a war loss is any deduction to which the taxpayer is entitled on account of any property or interest being treated as destroyed or seized under section 127, regardless of whether or not such deduction was claimed by the taxpayer or otherwise allowed in computing his tax. If a deduction was claimed by a taxpayer in computing his tax for any taxable year and if such deduction was disallowed, such deduction will not be considered an allowable deduction for such taxable year since the previous determination will not be reconsidered.

(b) *General rule; inclusion of recovery in gross income.* (1) A taxpayer who has sustained a war loss described in section 127 and who has not elected to have the provisions of section 127 (c) (3) apply to any taxable year in which he recovered any money or property in respect of a war loss in any previous taxable year must include in his gross income for each taxable year, to the extent provided in section 127 (c) (2) the amount of his recoveries of money and property for such taxable year in respect of any war loss in a previous taxable year. Section 127 (c) (2) provides that such recoveries for any taxable year are not includible in income until the taxpayer has recovered an amount equal to his allowable deductions in prior taxable years on account of such war losses which did not result in a reduction of any tax under chapter 1 of the Internal Revenue Code, that is, of any income tax of the taxpayer, or chapter 2, including the excess profits tax imposed by subchapter E thereof. War loss recoveries are considered as made first on account of war losses allowable but not actually allowed as a deduction, and second on account of war losses allowed as a deduction but which did not result in a reduction of tax under chapter 1 or chapter 2. If there were deductions allowed on account of war losses for two or more taxable years which did not result in a reduction of any tax under chapter 1 or chapter 2, a recovery on account of such losses is considered as made on account of such losses in the order of the taxable years for which they were allowed, beginning with the latest. See § 39.127 (f)-1 for the determination of the amount of such deductions. Recoveries in excess of such amount are treated as ordinary income until such excess equals the amount of the taxpayer's allowable deductions in prior taxable years on account of war losses which did result in a reduction of any such tax under chapter 1 or chapter 2. Any further recoveries in excess of all the taxpayer's allowable deductions in prior taxable years for war losses are treated as gain on an involuntary conversion of property as a result of its destruction or seizure, and such gain is recognized or not recognized under the provisions of section 112 (f) See § 39.112 (f)-1. Such gain, if recognized, is included in gross income as ordinary income unless section 117 (j) applies to cause such gain to be treated as gain from the sale or exchange of a capital asset held for more than six months. See § 39.117 (j)-1.

(2) The determination as to whether and to what extent any recoveries are to be included in gross income is made upon the basis of the amount of all the recoveries for each day upon which there are any such recoveries, as follows:

(i) The amount of the recoveries for any day is not included in gross income, and is not considered gain on an involuntary conversion, to the extent, if any, that the aggregate of the allowable deductions in prior taxable years on account of war losses which did not result in a reduction of any tax of the taxpayer under chapter 1 or chapter 2 of the Internal Revenue Code, as determined under § 39.127 (f)-1, exceeds the amount of all previous recoveries in the same and prior taxable years.

(ii) The amount of the recoveries for any day which is not excluded from gross income under subdivision (i) of this subparagraph is included in gross income as ordinary income, and is not considered gain on an involuntary conversion, to the extent, if any, that the aggregate of all the allowable deductions in prior taxable years on account of war losses (both those which resulted in a reduction of a tax of the taxpayer and those which did not) exceeds the sum of the amount of all previous recoveries in the same and prior taxable years and of that portion,

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if any, of the amount of the recoveries for such day which is not included in gross income under subdivision (i) of this subparagraph.

(iii) The amount of the recoveries for any day which is not excluded from gross income under subdivision (i) of this subparagraph and is not included in gross income as ordinary income under subdivision (ii) of this subparagraph is considered gain on an involuntary conversion of property as a result of its destruction or seizure. The following provisions then apply to this gain:

(*a*) Such gain is recognized or not recognized under the provisions of section 112 (f) relating to gain upon such conversion of property. For the purpose of applying section 112 (f), such gain for any day is deemed to be expended in the manner provided in section 112 (f) to the extent the recovery for such day is so expended.

(*b*) If such gain is recognized, it is included in gross income as ordinary income or, if the provisions of section 117 (j) apply and require such treatment, as gain on the sale or exchange of a capital asset held for more than six months. For the purpose of applying section 117 (j) such recognized gain for any day is deemed to be derived from property described in that section to the extent of the recovery for such day with respect to such property, except such portion of such recovery as is attributable to the nonrecognized gain for such day.

(*c*) Section 127 (d) provides that in determining the unadjusted basis of recovered property, the total gain and the recognized gain with respect to such property must be determined. For such purpose, the recognized gain deemed to be derived from properties described in section 117 (j) may be allocated among such properties in the proportion of the recoveries with respect to such properties, reduced for each property by the portion of the recovery attributable to the nonrecognized gain for such day, and the recoveries with respect to properties not described in section 117 (j) may be similarly allocated. The total gain derived from any recovered property is the sum of the nonrecognized gain attributable to the recovery of such property and of the recognized gain allocable to such property.

(3) The foregoing provisions may be illustrated by the following examples:

Example (1). The taxpayer sustained war losses of $3,000 on account of properties A, B, C, and D. Of this amount, $1,000 did not result in a reduction of any income tax of the taxpayer, as determined under the provisions of § 39.127 (f)-1. In a subsequent taxable year, he received an award of $800 from the Government on account of property A. This is not included in income since it is less than the amount by which his allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit, $1,000, exceed $0, the sum of all his previous recoveries. On a later date the taxpayer recovers property B, which is worth $1,500 on the date of recovery. This recovery is not included in gross income to the extent of $200, the amount by which the allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit, of $1,000, exceed the sum of all previous recoveries, or $800. All of the remaining $1,300 of the recovery is included in gross income as ordinary income, and is not considered gain on the involuntary conversion of property, since it is less than the amount by which the aggregate of all the allowable deductions in prior taxable years on account of war losses, or $3,000, exceeds $1,000, the sum of the $800 of previous recoveries and of the $200 portion of the recovery with respect to B which is not included in gross income. On a still later date the taxpayer sells for $2,500 his rights to recover C. Since the allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) do not exceed the previous recoveries by the taxpayer ($800 and $1,500, or $2,300), none of the recovery on account of C is excluded from gross income. This recovery is included in gross income as ordinary income, and is not considered gain on the involuntary conversion of property, to the extent of $700, the amount by which the aggregate of all the allowable deductions for prior taxable years on account of war losses ($3,000) exceeds $2,300, the sum of the $2,300 of previous recoveries and of the $0 portion of the recovery on account of C which is not included in gross income. The remaining $1,800 of the recovery is considered gain on an involuntary conversion of property on account of its destruction or seizure, and is not recognized if forthwith expended in the manner provided in section 112 (f). Thus, it is not recognized if it is forthwith expended for the acquisition of property relating in service or use to C. On a later date the taxpayer recovers D, which has a fair market value of $400 at the time of the recovery. Since the aggregate of all the allowable deductions for prior taxable years on account of war losses ($3,000) does not exceed the previous recoveries by the taxpayer ($800+$1,500+$2,500, or $4,800), all of the recovery with respect to D is considered gain on an involuntary conversion of property as a result of its destruction or seizure. Under the provisions of section 112 (f), this gain is not recognized if D is used for the same purposes for which it was used before it was deemed destroyed or seized under section 127.

Example (2). The taxpayer on one day recovers $3,000 for property A and $7,000 for property B, both of which were treated under section 127 as destroyed or seized in a prior taxable year, and $8,000 of such $10,000 recoveries is considered gain on the involuntary conversion of property as a result of its destruction or seizure. The taxpayer forthwith expends $5,000 in the acquisition of property similar in use to B. Therefore, $5,000 of the $8,000 gain is not recognized under section 112 (f), leaving $3,000 of recognized gain. Property B is within the provisions of section 117 (j), relating to gains and losses on the involuntary conversion of certain described property, but property A is not. Therefore, the provisions of section 117 (j) apply to $2,000 of the $3,000 gain, that is, the amount of the recovery with respect to B which is not attributable to the nonrecognized gain for such day ($7,000 minus $5,000). If the taxpayer forthwith expended $8,000 or more for the acquisition of property similar in use to B, none of the gain would be recognized. If the taxpayer forthwith expended the $5,000 to acquire property related in use to A, the $3,000 recognized gain would be considered derived from B to the extent of the recovery with respect to B ($7,000), not reduced by any nonrecognized gain since none of such recovery is attributable to such nonrecognized gain, and therefore all of the $3,000 recognized gain would be subject to the provisions of section 117 (j).

(c) *Elective method; tax adjustment measured by prior benefits.* (1) If the taxpayer elects pursuant to section 127 (c) (5) and in accordance with the provisions of these regulations to have the provisions of section 127 (c) (3) apply to any taxable year in which he recovers any money or property in respect of property considered under section 127 (a) as destroyed or seized in any previous taxable year, the amount of the recovery in respect of such property for any taxable year shall not be included in income until the taxpayer has recovered an amount equal to his allowable deductions in prior taxable years on account of the destruction or seizure of such property, whether or not such allowable deductions resulted in a reduction of any tax under chapter 1 or chapter 2 of the Internal Revenue Code. However, for the purposes of section 51, relating to the requirement of individual returns, section 52, relating to the requirement of corporation returns, and section 3801 (b), relating to the mitigation of the effect of the statute of limitations, the entire amount of the recovery shall be deemed to be an item includible in gross income for the taxable year in which the recovery is made. In lieu of including such amount in gross income, there shall be added to, and assessed and collected as a part of, the tax imposed under chapter 1 for the taxable year of the recovery an adjustment on account of any tax benefits in all prior taxable years resulting directly or indirectly from the fact that the loss from the destruction or seizure of such property was an allowable deduction. The amount of such adjustment shall be the total increase in the tax under chapter 1 of the Code, that is, any income tax of the taxpayer, and under chapter 2 including the excess profits tax imposed by subchapter E thereof, for all taxable years which would result by decreasing such allowable deductions with respect to the destruction or seizure of such property by an amount equal to that portion of the amount of the recovery which is not included in gross income for the taxable year of the recovery. The portion of the amount of the recovery which is in excess of such allowable deductions is included in gross income for the taxable year of the recovery as gain on the involuntary conversion of property as a result of its destruction or seizure and is recognized or not recognized as provided in section 112 (f) See § 39.112 (f)-1. Such gain, if recognized, is included in gross income as ordinary income unless section 117 (j) applies to cause such gain to be treated as gain on the sale or exchange of capital assets held for more than six months. See §39.117 (j)-1.

(2) The determination as to whether and to what extent the amount of the recovery is to be excluded from gross income is to be made upon the basis of the total amount of the recoveries in each taxable year in respect of the same property considered under section 127 (a) as destroyed or seized in any previous taxable year, as follows:

(i) The amount of the recovery in any taxable year is excluded from the

gross income of such year and is not considered gain on an involuntary conversion to the extent that such amount does not exceed the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of such property (whether or not such deductions resulted in a reduction of a tax of the taxpayer) reduced by the aggregate amount of any recoveries in intervening taxable years in respect of the same property.

(ii) The amount of the recovery in any taxable year which is not excluded from gross income under subdivision (i) of this subparagraph is included in gross income and is considered gain on an involuntary conversion of property as a result of its destruction or seizure. The following provisions apply to this gain:

(*a*) Such gain is recognized or not recognized under the provisions of section 112 (f) relating to gain upon such conversion of property. For the purpose of applying section 112 (f) such gain for any taxable year is deemed to be expended in the manner provided in section 112 (f) to the extent the recovery in such taxable year is so expended.

(*b*) If such gain is recognized it is included in gross income as ordinary income or, if the provisions of section 117 (j) apply and require such treatment, as gain on the sale or exchange of a capital asset held for more than six months. In the case of the recovery of the same property or interest considered under section 127 (a) as destroyed or seized, any gain will not be deemed to be recognized under the provisions of section 112 (f) if such property is used for the same purpose for which it was used before it was deemed destroyed or seized under section 127 (a)

(3) The determination of the total increase in the tax under chapters 1 and 2 of the Code for all taxable years which would result by decreasing the deductions allowable in any prior taxable years with respect to the destruction or seizure of the property in respect of which the taxpayer has made a recovery by an amount equal to the part of such recovery not included in gross income for the taxable year of such recovery shall be made as provided in this subparagraph. Such total increase shall include the increases described in subdivisions (i) (ii) (iii) and (iv) of this subparagraph, and shall be added to, and assessed and collected as a part of, the tax under chapter 1 for the taxable year of the recovery. Proper adjustment of such increases shall be made on account of the application of the provisions of this subparagraph to intervening taxable years. Proper adjustment shall also be made in the determination of such increases in the case of a taxpayer who has made a valid election under section 113 (d) relating to the adjustment of basis of property for depreciation, obsolescence, amortization, and depletion. The term "tax previously determined" as used in this subparagraph shall have the same meaning as used in section 3801 (d) of the Code and shall include any tax under chapter 1 or chapter 2 of the Code. In computing the amount of the increase in the tax previously determined under chapter 1 or chapter 2 for any taxable year, the principles of section 3801 (d) shall be applicable. See § 39.3801 (d)-1. However, the computation of the excess profits credit under chapter 2E for any taxable year shall not be affected by the adjustment provided in this subparagraph. All credits allowable against the tax for any year shall be taken into account in computing the increase in the tax previously determined. The increases referred to above include the following:

(i) The increase, if any, in the tax previously determined for each prior taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year. After the tax previously determined has been ascertained, such tax shall be recomputed by disregarding such allowable deduction (to the extent that it does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and any other deductions allowable on account of other war losses or any other losses, expenditures or accruals in such prior taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127 (c) (3), section 22 (b) (12) or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year.

(ii) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of the recovery) in which a net operating loss deduction was allowable, if all or a part of such deduction was attributable to the carry-over or carry-back to such taxable year of a net operating loss from another taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such net operating loss deduction. In the determination of such net operating loss deduction the net operating loss shall be recomputed by disregarding the deduction allowable on account of the war loss in respect of which there is a recovery in the taxable year to which such increase is to be added (to the extent that such deduction does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127 (c) (3), section 22 (b) (12) or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year.

(iii) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of recovery) in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment for such taxable year, if all or a part of such adjustment was attributable to the carry-over or carry-back to such taxable year of an unused excess profits credit from another taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such unused excess profits credit carry-over or carry-back. In the recomputation such carry-over or carry-back shall be redetermined by disregarding such allowable war loss deduction (to the extent such deduction does not exceed the sum of the amount of the recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127 (c) (3), section 22 (b) (12) or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year. In case there is an increase in the excess profits tax under chapter 2E for the taxable year in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment, and a decrease in the income tax under chapter 1 for such taxable year, the increase in the tax previously determined shall be considered to be an amount equal to the excess of the increase in the excess profits tax over the decrease in the income tax.

(iv) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of the recovery) in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment for such taxable year, if all or a part of such adjustment was attributable to the carry-over or carry-back to such taxable year of an unused excess profits credit from another taxable year in which there was allowable a net operating loss deduction attributable to the carry-over or carry-back to such other taxable year of a net operating loss, and such net operating loss resulted in whole or in part from the deduction allowable on account of the destruction or seizure of the property in respect of which there

is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such net operating loss deduction and such unused excess profits credit carry-over or carry-back. In the redetermination of such net operating loss deduction the net operating loss carry-over or carry-back shall be recomputed by disregarding such allowable war loss deduction (to the extent that such deduction does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127 (c) (3) section 22 (b) (12) or otherwise. The unused excess profits credit carry-over or carry-back shall then be recomputed to conform to the redetermination of the net operating loss deduction for the taxable year from which the unused credit is carried over or carried back. The difference between the tax previously determined and the tax as recomputed shall be the amount of the increase which shall be added to the tax for the taxable year of the recovery. In case there is an increase in the excess profits tax under chapter 2E for the taxable year in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment, and a decrease in the income tax under chapter 1 for such taxable year, the increase which shall be added to the tax for the taxable year of the recovery shall be considered to be an amount equal to the excess of the increase in the excess profits tax over the decrease in the income tax.

(d) *Elective method; time and manner of making election and effect thereof.* (1) If the taxpayer elects to have the provisions of section 127 (c) (3) applicable to any taxable year in which any money or property is recovered in respect of property considered under section 127 (a) as destroyed or seized, section 127 (c) (3) will be applicable by virtue of that election to all taxable years of the taxpayer beginning after December 31, 1941. Thus, the taxpayer need not make an election with respect to each separate taxable year in which he had a recovery. An election for any taxable year in which the taxpayer had a recovery in respect of a prior war loss is sufficient to make the provisions of section 127 (c) (3) applicable not only to war loss recoveries received by the taxpayer in any past taxable year beginning after December 31, 1941, but to any recoveries which may be received by the taxpayer in any future taxable year. Such election once made shall be irrevocable.

(2) The election of the taxpayer to have the provisions of section 127 (c) (3) applicable to any taxable year in which any money or property is recovered in respect of property considered under section 127 (a) as destroyed or seized must be made not later than December 31, 1952, unless the taxpayer recovers money or property (in respect of a prior war loss) during a taxable year ending after the date of the enactment of the Revenue Act of 1951 (October 20, 1951) If the taxpayer has a recovery during any taxable year ending after the date of the enactment of the Revenue Act of 1951, unless such taxable year is a taxable year ending on or before March 31, 1953, such election must be made by the taxpayer not later than the expiration of six months from the last day prescribed by law for the filing of his income tax return for such taxable year. However, if the taxpayer recovers any money or property (in respect of a prior war loss) during a taxable year ending after the date of the enactment of the Revenue Act of 1951 and on or before March 31, 1953, such election must be made not later than December 31, 1953. In all cases the election shall be made by a written statement that the taxpayer elects to have the provisions of section 127 (c) (3) apply to any taxable year in which any money or property is recovered in respect of property considered under section 127 (a) as destroyed or seized, which statement shall be made in (or attached to)—

(i) The return or amended return filed for such taxable year;

(ii) A claim for refund or credit filed for such taxable year for an overpayment resulting from the application of such provisions;

(iii) A timely petition or amended petition to The Tax Court of the United States for a redetermination of any deficiency for such taxable year;

(iv) A letter addressed to the district director of internal revenue for the district in which the return for such taxable year was required to be filed;

If the written statement of election is made in a letter, it shall be signed by the taxpayer making the election if an individual or, if the taxpayer is not an individual, the letter must be executed in the same manner as required in the case of the income tax return of such taxpayer. The date of the making of the election shall be the date the return, amended return, claim for refund or credit, or letter is filed in the office of the district director of internal revenue, or the date the petition or amended petition is filed with The Tax Court of the United States. In case the election is made in a return filed before the last day prescribed by law for the filing thereof (including any extension of time for such filing) such election shall not be considered made until such last day. In case the election is made in a letter addressed to the district director of internal revenue, such election will be considered as timely filed if it is placed in the mail on or before midnight of the last day prescribed by this paragraph for the making of the election, as shown by the postmark on the envelope containing the letter or as shown by other available evidence of the mailing date.

(3) If the provisions of section 127 (c) (3) are applicable to any taxable year pursuant to an election made by the taxpayer in accordance with the provisions of subparagraph (1) of this paragraph, the period of limitations provided in sections 275 and 276 of the Code on the making of assessments and the beginning of distraint or a proceeding in court for collection with respect to (i) the amount to be added to the tax for such taxable year under the provisions of section 127 (c) (3) and (ii) any deficiency for such taxable year or for any other taxable year to the extent attributable to the basis of the recovered property being determined under the provisions of section 127 (d) (2) shall not expire prior to the expiration of two years following the date of the making of such election. Such amount or such deficiency may be assessed at any time prior to the expiration of such period, notwithstanding any law or rule of law which would otherwise prevent such assessment and collection. No interest shall be assessed or collected with respect to any such amount or any such deficiency for any period prior to the expiration of six months following the date of the making of the election by the taxpayer.

(4) If the provisions of section 127 (c) (3) are applicable to any taxable year pursuant to an election made by the taxpayer in accordance with the provisions of subparagraph (1) of this paragraph, and refund or credit of any overpayment resulting from the application of such provisions to such taxable year is prevented on the date of the making of such election, or within one year from such date, by the operation of any law or rule of law (other than section 3761 relating to compromises) refund or credit of such overpayment may nevertheless be made or allowed, provided claim therefor is filed within one year from such date. Thus, the amount of such overpayment which may be refunded or credited is not subject to the limitations contained in section 322 (b) or (d). No interest shall be paid on any overpayment resulting from the application of the provisions of section 127 (c) (3) to any taxable year ending before the date of the making of the election by the taxpayer.

§ 39.127 (d) *Statutory provisions; war losses; basis of recovered property.*

SEC. 127. *War losses.* * * *

(d) *Basis of recovered property*—(1) *In general.* The unadjusted basis of property recovered in respect of property considered as destroyed or seized under subsection (a) shall be determined under this subsection. Such basis shall be an amount equal to the fair market value of such property, determined as of the date of the recovery, reduced by an amount equal to the excess of the aggregate of such fair market value and the amounts of previous recoveries of money or property in respect of property considered under subsection (a) as destroyed or seized over the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of property described in subsection (a), and increased by that portion of the amount of the recovery which under subsection (c) is treated as a recognized gain from the involuntary conversion of property. Upon application of the taxpayer, the aggregate of the bases (deter-

mined under the preceding sentence) of any properties recovered in respect of properties considered under subsection (a) as destroyed or seized may be allocated among the properties so recovered in such manner as the Secretary may determine under regulations prescribed by him, and the amounts so allocated to any such property so recovered shall be the unadjusted basis of such property in lieu of the unadjusted basis of such property determined under the preceding sentence.

(2) *Property recovered in taxable year to which subsection (c) (3) is applicable.* In the case of a taxpayer who has made an election under the provisions of subsection (c) (5), the basis of property recovered shall be an amount equal to the value at which such property is included in the amount of the recovery under subsection (c) (3) (A) (determined without regard to the last sentence thereof), reduced by such part of the gain under subsection (c) (3) (C) which is not recognized as provided in section 112 (f).

[Sec. 127 (d) as added by sec. 156 (a), Rev. Act 1942, amended by sec. 341 (b), Rev. Act 1951]

§ 39.127 (d)-1 *Basis of recovered property*—(a) *General rule.* (1) Under section 127 (d) (1) the unadjusted basis of any property treated as a war loss under section 127 which is recovered and the unadjusted basis of any property which is recovered in lieu of or on account of any such war loss is considered the fair market value of such recovered property upon the date of its recovery with the following adjustments:

(i) If the sum of the recoveries for the day such property is recovered and of all previous recoveries exceeds the aggregate of the allowable deductions for prior taxable years on account of war losses, so that a portion of the recoveries for such day is treated as gain on the involuntary conversion of property, such fair market value of the property is reduced by the total gain, if any, for such day derived from such recovered property, as determined under § 39.127 (c)-1 (b)

(ii) Such fair market value, as reduced under subdivision (i) of this subparagraph, is increased by the portion, if any, of the recognized gain resulting from the recoveries for such day which is allocable to such recovered property as determined under § 39.127 (c)-1 (b)

In effect, the unadjusted basis of such property is its fair market value upon the date of its recovery, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of § 39.127 (c)-1 (b).

(2) If the respective bases of several properties of a taxpayer determined under section 127 (d) (1) are greatly disproportionate to their adjusted bases immediately before their treatment as destroyed or seized property under section 127, the taxpayer may apply to the Commissioner for the allocation of the aggregate of the bases of such properties among them in the proportion of their adjusted bases immediately before the destruction or seizure of such properties determined under section 127. The amount so allocated to any such property, in an application approved by the Commissioner, shall be the unadjusted basis of such property in lieu of the amount determined under subparagraph (1) of this paragraph.

(3) The application to the Commissioner shall set forth a list of all the properties of the taxpayer having an unadjusted basis determined under this section, a description of each such property together with a statement as to the amount of its adjusted basis immediately before the destruction or seizure of such property determined under section 127, and a statement as to whether there has been any substantial change in the use or nature of the property chosen for the allocation from its nature or use immediately before the time it was treated as destroyed or seized. Such application will be allowed unless there has been such a substantial change in the nature or use of such property that the allocation of the bases would produce an arbitrary result, or unless the taxpayer has obtained such tax benefits by reason of the basis determined under subparagraph (1) of this paragraph, that it would be inequitable to change his basis. Thus, the allocation will not be allowed if it would give the taxpayer an unadjusted basis with respect to any property which is less than the amount of the adjustments in reduction of the basis of such property which are allowable after its recovery For example, when property A is recovered it has an unadjusted basis of $100. After $70 depreciation has been allowed on A, an allocation is sought which would give A an unadjusted basis of $60. Since this is less than the depreciation which is an adjustment against such basis, the allocation will not be permitted.

(4) The amount of any adjustments to the unadjusted basis determined under subparagraph (1) of this paragraph shall, upon the allocation of the bases, be taken as an adjustment to the allocated unadjusted basis. Thus, if $30 depreciation was allowed upon a $100 basis determined under subparagraph (1) of this paragraph and if the unadjusted basis upon allocation is $75, such $30 depreciation is allowed against such allocated unadjusted basis, so that the adjusted basis of the property is then $45.

(5) The taxpayer may choose any group of recovered properties for allocation, except that if any such recovered properties form one economic unit, such properties may not be separated but all or none must be included in the group. For example, a building may not be separated from the land on which it stands if both are recovered property, nor may one block of stock in a corporation be separated from other stock in such corporation or from bonds in such corporation which are also treated as a recovery. If the taxpayer has once been permitted to allocate the bases of any group of properties, he may obtain another allocation with respect to such properties only if all the properties in the original group are included together with other recovered properties not included in the original group. For example, if the bases of properties A and B are allocated, a second allocation will be made for properties A, B, and C, but not for A and C or B and C.

(b) *Property recovered in taxable year to which section 127 (c) (3) is applicable.* If, pursuant to an election made by the taxpayer under section 127 (c) (5) and § 39.127 (c)-1 (d), the provisions of section 127 (c) (3) are applicable to any taxable year in which the taxpayer recovered property in respect of a war loss under section 127, the unadjusted basis of such property shall be the fair market value of such property determined as of the date of the recovery, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of § 39.127 (c)-1 (c) However, if the property recovered is the same property or interest considered under section 127 (a) as destroyed or seized, and if the taxpayer under section 127 (c) (3) (A) includes such property or interest in the amount of the recovery at its adjusted basis (for determining loss) in his hands on the date such property or interest was considered under section 127 (a) as destroyed or seized, the unadjusted basis of such property shall be such adjusted basis, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of § 39.127 (c)-1 (c) The fair market value of any property recovered, or the adjusted basis (for determining loss) of such property or interest if the same property or interest treated as a war loss under section 127 is recovered, shall not be reduced in determining the unadjusted basis of such property or interest by the amount of the obligations or liabilities with respect to the property treated as a war loss under section 127 in respect of which the recovery was received, if the taxpayer for any previous taxable year chose under section 127 (b) (2) to treat such obligations or liabilities as discharged or satisfied out of such property but such obligations or liabilities were not so discharged or satisfied prior to the date of the recovery.

§ 39.127 (e)—(f) *Statutory provisions; war losses; partial worthlessness of certain investments; determination of tax benefits.*

Sec. 127. *War losses.* * * *

(e) *Partial worthlessness of certain investments in destroyed or seized property*—(1) *Destruction or seizure of investment.* If a taxpayer owns not less than 50 per centum of each class of stock of a corporation, if such corporation has property described in subsection (a) (1) or (2) deemed to be destroyed or seized, the adjusted basis for determining loss of which is at least 75 per centum of the adjusted basis for determining loss of all such corporation's property, and if such corporation completely liquidates (by distributing all the assets which it is able to distribute and all its rights to assets which it is not able to distribute, including the right to the recovery of the property described in subsection (a) (1) and (2)) within one year after such property is deemed to be destroyed or seized, or within six months after the date of the enactment of the Revenue Act of 1942, whichever is the later, then that part of the loss by the taxpayer on such liquidation which would be attributable to the destruction or seizure of such property, as established to the satisfaction of the Commissioner, shall be treated for the purposes of this chapter as a loss by the taxpayer upon the destruction or seizure of the part of the stock or other interest of the taxpayer to

which such loss is allocable. Such part of the stock or other interest of the taxpayer shall be treated for the purposes of subsections (b), (c), and (d) as property described in subsection (a) (3).

(2) *Application of paragraph (1)*. For the purposes of paragraph (1)—

(A) In determining the adjusted basis of all the property of the corporation, there shall be excluded money in the United States, bank deposits, the right to receive money from any person not situated in a country at war with the United States or in a territory under the control of such a country, and obligations issued or guaranteed as to principal or interest by the United States, except that there shall not be excluded any such property which is destroyed or seized as described in subsection (a) within or before the taxable period.

(B) The adjusted basis of property of such corporation shall be determined as of the date immediately preceding the first date on which any property was destroyed or seized, as described in subsection (a), or as of any later date falling within or before the taxable period on the basis of which such determination will produce a greater amount.

[Sec. 127 (e) as added by sec. 156 (a), Rev. Act 1942]

(f) *Determination of tax benefits*. The determination as to whether and to what extent an allowable deduction on account of the destruction or seizure of property described in subsection (a) did or did not result in a reduction of any tax of the taxpayer under this chapter shall be made in accordance with regulations prescribed by the Commissioner with the approval of the Secretary.

[Sec. 127 (f) as added by sec. 156 (a), Rev. Act 1942]

§ 39.127 (f)-1 *Determination of tax benefits from allowable deductions*. (a) That part of the aggregate of the deductions allowed a taxpayer for any taxable year on account of war losses under section 127 which, if disallowed, would not result in an increase in the normal tax, surtax (including the tax imposed by section 102) or victory tax of taxpayer, or of any tax imposed in lieu of such taxes or of any tax imposed by chapter 2 of the Internal Revenue Code, for the taxable year in which such deductions are allowed or in any other taxable year, such as a taxable year in which the taxpayer's income tax is computed by reference to a carry-over or carry-back of net operating losses from the taxable year in which such deductions are allowed, is considered, for the purposes of section 127, an allowable deduction for the taxable year which did not result in a reduction of any tax of the taxpayer under chapter 1 or chapter 2 of the Code. In the case of recoveries of war losses and other items to which the recovery exclusion provisions of section 22 (b) (12) apply, such as bad debts, the determination of the tax benefit should be made in accordance with paragraph (b) of § 39.22 (b) (12)-1. The deductions allowed a taxpayer for any taxable year on account of war losses are all the deductions on account of war losses which were claimed by the taxpayer in a return, in a claim for credit or refund of an overpayment, or in a petition to The Tax Court of the United States with respect to such taxable year and which were not disallowed, and all deductions on account of war losses which, although not so claimed by the taxpayer, were nevertheless allowed (for example, by the Commissioner, a court, or The Tax Court) in computing a tax of the taxpayer.

(b) Any deduction allowable for a taxable year on account of a war loss under section 127 which was not claimed by the taxpayer for such year in a return, a claim for credit or refund of an overpayment, or a petition to The Tax Court of the United States and was not allowed as a deduction (for example, by the Commissioner, a court, or The Tax Court) in computing his tax for such year or for any other year is considered a deduction which did not result in a reduction of any tax of the taxpayer under chapter 1 or chapter 2 of the Internal Revenue Code, since it is an allowable deduction which was not allowed in computing any tax of the taxpayer. If the taxpayer claimed for any taxable year a deduction on account of a war loss, and if such deduction was disallowed, the taxpayer may not subsequently contend for the purposes of section 127 (c) that such deduction was an allowable deduction for such taxable year.

(c) If the taxpayer elected under section 127 (b) to decrease the amount of a war loss by treating the obligations and liabilities described in that section as discharged or satisfied out of the property destroyed or seized, and if the taxpayer establishes that any of the obligations and liabilities were not so discharged or satisfied, then the amount by which such continuing obligations and liabilities decreased the war loss shall be considered an allowable deduction for the taxable year in which the war loss was sustained which did not result in a reduction of any tax of the taxpayer under chapter 1 or chapter 2 of the Internal Revenue Code.

§ 39.128 *Statutory provisions; recovery of unconstitutional Federal taxes*.

SEC. 128. *Recovery of unconstitutional Federal taxes*. Income (excluding interest) attributable to the recovery during the taxable year of a tax imposed by the United States which has been held unconstitutional, and in respect of which a deduction was allowed in a prior taxable year may be excluded from gross income for the taxable year, and the deduction allowed in respect thereof in such prior taxable year treated as not having been allowable, if—

(a) The taxpayer elects in writing (at such time and in such manner as may be prescribed by regulations prescribed by the Commissioner with the approval of the Secretary) to treat such deduction as not having been allowable for such prior taxable year, and

(b) The taxpayer consents in writing to the assessment, within such period as may be agreed upon, of any deficiencies resulting from such treatment, even though the statutory period for the assessment of any such deficiency had expired prior to the filing of such consent.

[Sec. 128 as added by sec. 157 (a), Rev. Act 1942]

§ 39.128-1 *Recovery of unconstitutional taxes*—(a) *In general*. (1) Subject to the limitations herein, a taxpayer who recovers unconstitutional Federal taxes which were paid or accrued and for which a deduction was allowed in a prior taxable year is entitled at his election (see paragraph (b) of this section) to exclude the income (exclusive of interest) attributable to such recovery from his gross income in the taxable year of recovery.

(2) In the event a taxpayer elects to receive the benefits of section 128, the income (exclusive of interest) attributable to the recovery of the unconstitutional Federal tax will be treated as an offset to the deduction allowed therefor in prior taxable years. The taxpayer's return for the prior taxable year or years with respect to which the statutory period for the assessment of a deficiency has expired will be opened only for the purpose of reducing the deduction allowed for the unconstitutional Federal tax and assessing the resulting deficiency or deficiencies, if any, and only if the taxpayer consents in writing to the assessment (see paragraph (b) of this section) No other adjustment will be allowed.

(3) In the event the disallowance of the deduction allowed in respect of a prior taxable year results in a deficiency for that year, the deficiency will be assessed within the period agreed upon between the taxpayer and the Commissioner, in respect of the taxable year of the prior deduction, against the taxpayer (who must file a written consent to the assessment as provided in paragraph (b) of this section) even though the statutory period for the assessment may have expired prior to the filing of the consent.

(4) If a taxpayer does not elect under the provisions of section 128 to exclude the tax recovered from gross income in the taxable year of recovery, the tax recovered shall, from the standpoint of its inclusion in or exclusion from gross income, be governed by the provisions of section 22 (b) (12)

(5) Where a taxpayer's liability for income tax with respect to the deduction or the recovery or with respect to the tax liability for the year of the deduction or recovery has been finally determined by a written agreement or by a decision of The Tax Court of the United States or of any court, the taxpayer will not be entitled to the benefits of section 128 or of this section. As to taxability of refund of taxes generally, see section 22 (b) (12).

(b) *Manner of making election*. (1) The election provided for in paragraph (a) of this section shall be made by the taxpayer filing a statement in writing that he elects to treat the deduction allowed in a prior taxable year for the unconstitutional tax as not having been allowable for such taxable year. Such a statement must be filed with the taxpayer's return for the taxable year in which the recovery of the unconstitutional tax or taxes occurs. No other method of making the election is permitted. The statement of election must contain a description of the tax recovered, the date of recovery, the taxable year in which paid or accrued, and the taxable year for which the deduction was allowed. The statement of election must also contain a statement signifying the taxpayer's consent (i) to the Com-

missioner's treating the deduction or portion thereof allowed in a prior year with respect to the unconstitutional tax as not allowable for that year and (ii) to the Commissioner's assessing, in respect of the taxable year for which the deduction was allowed, any deficiency, together with interest thereon as provided by law, resulting from disallowance of the deduction or portion thereof, even though the statutory period for the assessment of any such deficiency may have expired before the filing of such consent.

(2) As used in this section, the term "recovery" includes not only refund or credit of taxes previously paid, but includes also the cancellation of a purported tax liability which was accrued and deducted for a prior taxable year but never actually paid.

§ 39.129 *Statutory provisions; acquisitions made to evade or avoid income or excess profits tax.*

SEC. 129. *Acquisitions made to evade or avoid income or excess profits tax*—(a) *Disallowance of deduction, credit, or allowance.* If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation, or (2) any corporation acquires, on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately prior to such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For the purposes of clause (1) and (2), control means the ownership of stock possessing at least 50 per centum of the total combined voting power of all classes of stock entitled to vote or at least 50 per centum of the total value of shares of all classes of stock of the corporation.

(b) *Power of commissioner to allow deduction, etc., in part.* In any case to which subsection (a) is applicable the Commissioner is authorized—

(1) To allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(2) To distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(3) To exercise his powers in part under paragraph (1) and in part under paragraph (2).

[Sec. 129 as added by sec. 128 (a), Rev. Act 1943]

§ 39.129-1 *Meaning and use of terms.* As used in section 129 and the regulations thereunder—

(a) The term "allowance" refers to anything in the internal revenue laws which has the effect of diminishing tax liability. The term includes, among other things, a deduction, a credit, an adjustment, an exemption, or an exclusion.

(b) The phrase "evasion or avoidance" is not limited to cases involving criminal penalties, or civil penalties for fraud.

(c) The phrase "Federal income or excess profits tax" refers to any Federal tax imposed by Congress upon an income base.

(d) The term "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote; or at least 50 percent of the total value of shares of all classes of stock of the corporation. To "acquire, on or after October 8, 1940,* * * control," it is not necessary that all of such stock be acquired on or after October 8, 1940. Thus, if A, on October 7, 1940, and at all times thereafter, owns 40 percent of the stock of Corporation X and acquires on October 8, 1940, an additional 10 percent of such stock, an acquisition within the meaning of such phrase is made by A on October 8, 1940. Similarly, if B, on October 7, 1940, owns certain assets and transfers on October 8, 1940, such assets to a newly organized Corporation Y in exchange for all the stock of Corporation Y, an acquisition within the meaning of such phrase is made by B on October 8, 1940. If, under the facts stated in the preceding sentence, B is a corporation, all of whose stock is owned by Corporation C, then an acquisition within the meaning of such phrase is also made by Corporation C on October 8, 1940, by the shareholders taken as a group on such date, and by any of such shareholders if such shareholders as a group own 50 percent of the stock of C on such date.

(e) The term "person" includes an individual, a trust, an estate, a partnership, a company, or a corporation.

§ 39.129-2 *Purpose and scope of section 129.* (a) Section 129 is designed to prevent in the instances specified therein the use of the sections of the Internal Revenue Code providing deductions, credits, or allowances in evading or avoiding Federal income or excess profits taxes. See § 39.129-3.

(b) Under the Code, an amount otherwise constituting a deduction, credit, or other allowance becomes unavailable as such under certain circumstances. Characteristic of such circumstances are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. The distortion may be evidenced, for example, by the fact that the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer, by the unreal nature of the transaction such as its sham character, or by the unreal or unreasonable relation which the deduction, credit, or other allowance bears to the transaction. The principle of law making an amount unavailable as a deduction, credit, or other allowance in cases in which the effect of making an amount so available would be to distort the liability of the taxpayer, has been judicially recognized and applied in several cases. Included in these cases are Gregory v. Helvering (1935) (293 U. S. 465), Griffiths v. Helvering (1939) (308 U. S. 355), Higgins v. Smith (1940) (308 U. S. 473), and J. D. & A. B. Spreckles Co. v. Commissioner (1940) (41 B. T. A. 370) In order to give effect to such principle, but not in limitation thereof, several provisions of the Code, for example, section 24 (b) and (c) and section 130, specify with some particularity instances in which disallowance of the deduction, credit, or other allowance is required. Section 129 is also included in such provisions of the Code. The principle of law and the particular sections of the Code are not mutually exclusive and in appropriate circumstances they may operate together or they may operate separately.

§ 39.129-3 *Instances in which section 129 (a) disallows a deduction, credit, or other allowance.* (a) Section 129 specifies two instances in which a deduction, credit, or other allowance is to be disallowed. These instances, described in clauses (1) and (2) of section 129 (a), are those in which:

(1) Any person or persons acquire, directly or indirectly, on or after October 8, 1940, control of a corporation; and

(2) Any corporation acquires, directly or indirectly, on or after October 8, 1940, property of another corporation (not controlled, directly or indirectly, immediately prior to such acquisition by such acquiring corporation or its stockholders) the basis of which property in the hands of the acquiring corporation is a substituted basis.

In either instance the principal purpose for which the acquisition was made must have been the evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy. The principal purpose actuating the acquisition must have been to secure the benefit which such person or persons or corporation would not otherwise enjoy. If this requirement is satisfied, it is immaterial by what method or by what conjunction of events the benefit was sought. If the purpose to evade or avoid Federal income or excess profits tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquistions fall within the provisions of section 129 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom.

(b) If the requisite acquisition and purpose exist, among the transactions

within clause (1) of section 129 (a) are the following:

(1) A corporation (or the interest controlling such a corporation) with large profits acquires control of another corporation with current, past, or prospective credits, deductions, net operating losses, unused excess profits credits, or other allowances and the acquisition is followed by such transfers or other action as is necessary to bring the deduction, credit, or other allowance into conjunction with the income; or

(2) A corporation with large profits transfers the assets of each of its branches or departments to newly organized corporations in order to secure the benefit of the minimum excess profits credit provided in section 431, or

(3) A corporation with high earning assets transfers them to a newly organized subsidiary retaining assets likely to produce losses or to be disposed of at a loss for the purpose of securing refunds through a utilization of the unused excess profits carry-back or the net operating loss carry-back.

(c) If the requisite acquisition and purpose exist, among the transactions within clause (2) of section 129 (a) is the following: A corporation acquires property having in its hands a substituted basis which is materially greater than its fair market value at the time of such acquisition in order to secure a larger excess profits credit or to utilize the property to create tax-reducing losses.

§ 39.129-4 *Power of Commissioner to allocate deduction, credit, or allowance in part.* The Commissioner is authorized by section 129 (b) to allow a part of the amount disallowed by section 129 (a) but he may allow such part only if and to the extent that he determines that the amount allowed will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made. The Commissioner is also authorized to use other methods to give effect to part of the amount disallowed under section 129 (a) but only to such extent as he determines will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made. Whenever appropriate to give proper effect to the deduction, credit, or other allowance, or such part of it which may be allowed, this authority includes the distribution, apportionment, or allocation of both the gross income and the deductions, credits, or other allowances the benefit of which was sought, between or among the corporations, or properties, or parts thereof, involved, and includes the disallowance of any such deduction, credit, or other allowance to any of the taxpayers involved.

§ 39.130 *Statutory provisions; limitation on deductions allowable to individuals in certain cases.*

SEC. 130. *Limitation on deductions allowable to individuals in certain cases*—(a) *Recomputation of net income.* If the deductions (other than taxes and interest) allowable to an individual (except for the provisions of this section) and attributable to a trade or business carried on by him for five consecutive taxable years have, in each of such years, exceeded by more than $50,000 the gross income derived from such trade or business, the net income of such individual for each of such years shall be recomputed. For the purpose of such recomputation in the case of any such taxable year, such deductions shall be allowed only to the extent of $50,000 plus the gross income attributable to such trade or business, except that the net operating loss deduction, to the extent attributable to such trade or business shall not be allowed.

(b) *Redetermination of tax.* Upon the basis of the net income computed under the provisions of subsection (a) for each of the five consecutive taxable years specified in such subsection, the tax imposed by this chapter shall be redetermined for each such taxable year. If for any such taxable year assessment of a deficiency is prevented (except for the provisions of sections 3801 and 3807) by the operation of any law or rule of law (other than section 3761, relating to compromises) any increase in the tax previously determined for such taxable year shall be considered a deficiency for the purposes of this section. For the purposes of this section the term "tax previously determined" shall have the meaning assigned to such term by section 3801 (d).

(c) *Extension of statute of limitations.* Notwithstanding any law or rule of law (other than section 3761, relating to compromises), any amount determined as a deficiency under subsection (b), or which would be so determined if assessment were prevented in the manner described in subsection (b), with respect to any taxable year may be assessed as if on the date of the expiration of the time prescribed by law for the assessment of a deficiency for the fifth taxable year of the five consecutive taxable years specified in subsection (a), one year remained before the expiration of the period of limitation upon assesment for any taxable year.

[Sec. 130 as added by sec. 129 (a), Rev. Act 1943]

§ 39.130-1 *Limitation on deductions allowable to individuals in certain cases*—(a) *Recomputation of net income.* (1) Section 130 serves to limit the deductions, other than taxes and interest, attributable to a trade or business carried on by an individual which are otherwise allowable to such individual under the provisions of chapter 1. If in each of five consecutive taxable years the deductions attributable to a trade or business, except the deduction for interest and except the deduction for taxes, exceed the gross income derived from such trade or business by more than $50,000, the net income of such individual must be recomputed for each of such five taxable years. In recomputing the net income for each of the five taxable years, deductions (other than those for interest and taxes) attributable to the trade or business, and otherwise allowable under chapter 1, shall be allowed only to the extent of (i) the gross income derived from the trade or business, plus (ii) $50,000. The deduction for interest and the deduction for taxes shall each be allowed in full. The net operating loss deduction provided in section 23 (s) to the extent attributable to the given trade or business, shall be disallowed in its entirety in making such recomputation. Thus, any carry-over or carry-back of a net operating loss, so attributable, either from a year within the period of five consecutive taxable years or from a year outside of such period, shall be ignored in making the recomputation of net income. However, the net operating loss deduction provided in section 23 (s) shall be included in determining whether the deductions (other than the deduction for interest and the deduction for taxes) otherwise allowable under chapter 1, which are attributable to a trade or business exceed the gross income derived from such trade or business by more than $50,000 in any taxable year. The limitations on deductions provided by section 130 are applicable in determining under section 122 the amount of any net operating loss carry-over or carry-back from any year which falls within the provisions of section 130 to any year which does not fall within such provisions. Also in determining under section 122 the amount of any net operating loss carry-over from a year which falls within the provisions of section 130 to a year which does not fall within such provisions, the amount of the net operating loss is to be reduced by the net income (computed as provided in § 39.122-4 (c) and, in the case of any taxable year which falls within the provisions of section 130, determined after the application of section 130) of any taxable year preceding or succeeding the taxable year of the net operating loss to which such loss must first be carried back or carried over under the provisions of section 122 (b) even though the net operating loss deduction is not an allowable deduction for such preceding or succeeding taxable year.

(2) If an individual carries on several trades or businesses, the deductions attributable to such trades or businesses, and the gross income derived from such trades or businesses, shall not be aggregated in determining whether the deductions (other than those for interest and taxes) exceed the gross income derived from such trades or businesses by more than $50,000 in any taxable year. Each trade or business shall be considered separately. The trade or business carried on by the individual must be the same in each of the five consecutive taxable years in which the deductions (other than those for interest and taxes) exceed the gross income derived from such trade or business by more than $50,000.

(3) For purposes of section 130, a given taxable year may be part of two or more different periods of five consecutive taxable years. Thus, if the deductions, other than taxes and interest, attributable to a trade or business carried on by an individual exceed the gross income from such business by more than $50,000 for each of six consecutive taxable years, the fifth year of such six consecutive taxable years shall be considered to be a part both of a five-year period beginning with the first and ending with the fifth taxable year and of a five-year period beginning with the second and ending with the sixth taxable year.

(b) *Redetermination of tax.* The tax imposed by chapter 1 for each of the five consecutive taxable years specified in paragraph (a) of this section shall be redetermined upon the basis of the net income of the individual recomputed in

the manner described in paragraph (a) of this section. If the assessment of a deficiency is prevented (except for the provisions of section 3801, relating to mitigation of effect of limitation and other provisions in income tax cases, or 3807, relating to period of limitation in case of related taxes under chapter 1 and chapter 2) by the operation of any provision of law (e. g., sections 275 and 276, relating to the period of limitation upon assessment and collection) except section 3761, relating to compromises, or by any rule of law (e. g., res judicata) then the excess of the tax for such year as recomputed over the tax previously determined for such year shall be considered a deficiency for purposes of section 130. The term "tax previously determined" shall have the same meaning as that assigned to such term by section 3801 (d) See § 39.3801 (d)-1.

(c) *Assessment of tax.* Any amount determined as a deficiency in the manner described in paragraph (b) of this section in respect of any taxable year of the five consecutive taxable years specified in paragraph (a) of this section may be assessed and collected as if on the date of the expiration of the period of limitation for the assessment of a deficiency for the fifth taxable year of such five consecutive taxable years, one year remained before the expiration of the period of limitation upon assessment for the taxable year in respect of which the deficiency is determined. If the taxable year is one in respect of which an assessment could be made without regard to section 130, the amount of the actual deficiency as defined in section 271 (whether it is greater than, equal to, or less than the deficiency determined under section 130 (b)) shall be assessed and collected. However, if the assessment of a deficiency for such taxable year would be prevented by any provision of law (e. g., the period of limitation upon the assessment of tax) except section 3761, relating to compromises, or by the operation of any rule of law (e. g., res judicata) then the excess of the tax recomputed as described in paragraph (b) of this section over the tax previously determined may be assessed and collected even though in fact there is no actual deficiency, as defined in section 271, in respect of the given taxable year.

§ 39.130A *Statutory provisions; employee stock options.*

SEC. 130A. *Employee stock options*—(a) *Treatment of restricted stock options.* If a share of stock is transferred to an individual pursuant to his exercise after 1949 of a restricted stock option, and no disposition of such share is made by him within two years from the date of the granting of the option nor within six months after the transfer of such share to him—

(1) No income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(2) No deduction under section 23 (a) shall be allowable at any time to the employer corporation of such individual or its parent or subsidiary corporation with respect to the share so transferred; and

(3) No amount other than the option price shall be considered as received by either of such corporations for the share so transferred.

This subsection and subsection (b) shall not apply unless (A) the individual, at the time he exercises the restricted stock option, is an employee of the corporation granting such option or of a parent or subsidiary corporation of such corporation, or (B) the option is exercised by him within three months after the date he ceases to be an employee of any of such corporations.

(b) *Special rule where option price is between 85 percent and 95 percent of value of stock.* If no disposition of a share of stock acquired by an individual upon his exercise after 1949 of a restricted stock option is made by him within two years from the date of the granting of the option nor within six months after the transfer of such share to him, but, at the time the restricted stock option was granted, the option price was less than 95 per centum of the fair market value at such time of such share, then, in the event of any disposition of such share by him, or in the event of his death (whenever occurring) while owning such share, there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income, for the taxable year in which falls the date of such disposition or for the taxable year closing with his death, whichever is applicable, an amount equal to the amount (if any) by which the option price is exceeded by the lesser of—

(1) The fair market value of the share at the time of such disposition or death, or

(2) The fair market value of the share at the time the option was granted.

In the case of the disposition of such share by the individual, the basis of the share in his hands at the time of such disposition shall be increased by an amount equal to the amount so includible in his gross income.

(c) *Acquisition of new stock.* If stock transferred to an individual upon his exercise of the option is exchanged by him for stock or securities in an exchange within the provisions of section 112 (b) (2) or (3), or if new stock, as described in section 113 (a) (19), is acquired upon a distribution with respect to such stock, the stock or securities acquired in such exchange and such new stock shall be considered as having been transferred to him upon his exercise of such option. A similar rule shall be applied in the case of a series of such exchanges or acquisitions.

(d) *Definitions.* For the purposes of this section—

(1) *Restricted stock option.* The term "restricted stock option" means an option granted after February 26, 1945, to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if—

(A) At the time such option is granted the option price is at least 85 per centum of the fair market value at such time of the stock subject to the option; and

(B) Such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(C) Such individual, at the time the option is granted, does not own stock possessing more than 10 per centum of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation. For the purposes of this subparagraph—

(i) Such individual shall be considered as owning the stock owned, directly or indirectly, by or for his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

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

(2) *Parent corporation.* The term "parent corporation" means any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time of granting of the option, each of the corporations other than the employer corporation owns stock possessing more than 50 per centum of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(3) *Subsidiary corporation.* The term "subsidiary corporation" means any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing more than 50 per centum of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(4) *Disposition.* The term "disposition" includes a sale, exchange, gift, or any transfer of legal title, but does not include—

(A) A transfer from a decedent to his estate or a transfer by bequest or inheritance;

(B) An exchange which is within the provisions of section 112 (b) (2) or (3); or

(C) A mere pledge or hypothecation.

(5) *Stockholder approval.* If the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval.

(e) *Modification, extension, or renewal of option.* For the purposes of subsection (d), if the terms of any option to purchase stock are modified, extended, or renewed, the following rules shall be applied with respect to transfers of stock made upon an exercise of the option after the making of such modification, extension, or renewal:

(1) Such modification, extension, or renewal shall be considered as the granting of a new option;

(2) The fair market value of such stock at the time of the granting of such option shall be considered as (A) the fair market value of such stock on the date of the original granting of the option, (B) the fair market value of such stock on the date of the making of such modification, extension, or renewal, or (C) the fair market value of such stock at the time of the making of any intervening modification, extension, or renewal, whichever is the highest.

[Sec. 130A as added by sec. 218 (a), Rev. Act 1950; amended by sec. 331, Rev. Act 1951]

§ 39.130A-1 *Meaning and use of certain terms*—(a) *Option.* (1) For the purpose of section 130A, the term "option" includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a stated price, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at a stated option price and the period of time dur-

ing which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract.

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1952, grants to an employee the right to purchase 1,000 shares of its stock on or after June 1, 1953, another 1,000 shares on or after June 1, 1954, and a further 1,000 shares on or after June 1, 1955, all shares to be purchased before June 1, 1956, provided the employee at the time of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1952, of three options, each for the purchase of 1,000 shares. Similarly, if a corporation grants to an employee on January 1, 1953, the right to purchase 1,000 shares of its stock at $85 per share during 1953, at $75 per share during 1954, and at $65 per share during 1955, such an arrangement will be construed as the grant to the employee on January 1, 1953, of three alternative options, one option for the purchase of 1,000 shares at $85 per share during 1953, an alternative option for the purchase of 1,000 shares at $75 per share during 1954, and a third alternative option for the purchase of 1,000 shares at $65 per share during 1955.

(b) *Time and date of granting of option.* (1) For the purpose of section 130A, the words "the date of the granting of the option" and "the time such option is granted" and similar phrases refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a restricted stock option. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given. If the terms of the offer do not specify the amount of the option price, the option will not be considered granted before the date on which the amount of the option price becomes fixed or determinable.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option) such conditions shall be given effect in accordance with the intent of the corporation. A special rule is provided by section 130A (d) (5) for options subject to stockholder approval. If the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporate action, such as the approval of some regulatory or governmental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of its parent or subsidiary corporation, such option is not granted prior to the date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 1952, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation stock, exercisable by X on or after June 1, 1953, provided he is employed by the corporation on June 1, 1953. Such an option is granted to X on June 1, 1952.

(c) *Stock.* For the purpose of section 130A, the term "stock" means capital stock of any class, including voting or nonvoting common or preferred stock. The term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term "stock" as used in section 130A, provided such stock otherwise possesses the rights and characteristics of capital stock.

(d) *Option price.* For the purpose of section 130A, the term "option price" means the consideration in money or property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased.

(e) *Exercise.* For the purpose of section 130A, the term "exercise" when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee. If the terms of the offer do not specify the amount of the option price, the option will not be considered exercised prior to the date on which the amount of the option price becomes fixed or determinable.

(f) *Transfer.* For the purpose of section 130A, the term "transfer" when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a restricted stock option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation.

§ 39.130A–2 *Restricted stock option*—(a) *In general.* (1) A "restricted stock option" is an option granted after February 26, 1945, to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if (i) at the time such option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option; and (ii) such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and (iii) such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock either of the employer corporation or of its parent or subsidiary corporation.

(2) At the time the option is granted, the relationship between the individual to whom an option is granted and the corporation granting the option (or a corporation which is a parent or subsidiary thereof) must be the legal and bona fide relationship of employer and employee. For rules applicable to the determination whether the employer-employee relationship exists, see § 405.104 of this chapter (Regulations 116) relating to collection of income tax at source on wages. An option granted prior to employment or after termination of employment is not a restricted stock option. As to the granting of an option conditioned upon employment, see paragraph (b) of § 39.130A–1. The option must be granted for a reason connected with the individual's employment by the corporation or by its parent or subsidiary corporation. An option may qualify as a restricted stock option only if, under the terms of the option, it is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom it is granted, and is exercisable, during the lifetime of such individual, only by him. Accordingly, an option which is transferable by the individual to whom it is granted during his lifetime, or is exercisable during such individual's lifetime by another person, is not a restricted stock option.

(b) *Ownership of 10 percent of stock.* In determining the amount of stock owned by an individual, for the purpose of applying the 10 percent test of section 130A (d) (1) (C) stock of the employer corporation or of its parent or subsidiary owned (directly or indirectly) by or for such individual's brothers and sisters (whether by the whole or half blood) spouse, ancestors, and lineal descendants, shall be considered as owned by such individual. For the purpose of section 130A, if a corporation, partnership, estate, or trust owns (directly or indirectly) stock of the employer corporation or of its parent or subsidiary, such stock shall be considered as being owned proportionately by or for the shareholders, partners, or beneficiaries of the corporation, partnership, estate, or trust.

§ 39.130A–3 *Exercise of restricted stock option.* (a) The special rules of

income tax treatment provided in section 130A (a) and (b) are applicable only if the following conditions exist with respect to the transfer of a share of stock to an individual:

(1) The share of stock is transferred to the individual pursuant to his exercise after 1949 of a restricted stock option; and

(2) At the time the option is exercised by him, the individual is an employee of the corporation granting such option (or of a parent or subsidiary thereof) or was an employee of any such corporations within three months prior to the date the option is exercised.

(b) The special treatment provided in section 130A (a) and (b) shall apply only if the restricted stock option is exercised by the individual to whom it was granted. Such special treatment shall not be applicable with respect to stock transferred pursuant to the exercise of the option by the individual's executor, administrator, heir, or legatee. Under the provisions of section 130A (d) (1) (B) an option may qualify as a restricted stock option although it is transferable at death to the individual's executor, administrator, heir, or legatee. Thus, the fact that a restricted stock option may be exercised by an executor, administrator, heir, or legatee does not deprive the individual who exercises such option during his lifetime of the special treatment provided in section 130A.

(c) At the time of exercise of a restricted stock option, the status of the individual exercising such option must be that of a bona fide employee of the corporation granting the option or that of a bona fide employee of a parent or subsidiary of such corporation, or such individual must have been a bona fide employee of any such corporation within three months previous to the date of exercise.

(d) (1) The determination whether an option ultimately exercised is a restricted stock option is made as of the date such option is granted. An option which is a restricted stock option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a restricted stock option when granted does not become such an option by reason of subsequent events. See, however, § 39.130A-4, relating to modification, extension, or renewal of an option.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). S-1 Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 1952, P grants to an employee of P a restricted stock option to purchase a share of stock of S-1. On January 1, 1953, S sells a portion of the S-1 stock which it owns to an unrelated corporation and, as of that date, S-1 ceases to be a subsidiary of S. On May 1, 1953, while still employed by P the employee exercises his option to purchase a share of S-1 stock. The employee has exercised a restricted stock option.

Example (2). Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1952, S-1 is not a subsidiary of either S or P. Such option is not a restricted stock option on June 1, 1952. On January 1, 1953, S purchases from an unrelated corporation a sufficient number of shares of S-1 stock to make S-1, as of that date, a subsidiary of S. On May 1, 1953, while still employed by P, the employee exercises his option to purchase a share of S-1 stock. The employee has not exercised a restricted stock option.

§ 39.130A-4 *Modification, extension, or renewal.* (a) Section 130A (e) provides rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a restricted stock option. For the purpose of such determination, the statute provides that:

(1) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option; and

(2) The fair market value of the stock subject to the option at the time of the granting of such option shall be considered as the fair market value of such stock (i) on the date of the original granting of the option, (ii) on the date of the making of such modification, extension, or renewal, or (iii) at the time of the making of any intervening modification, extension, or renewal, whichever is the highest.

(b) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in paragraph (b) of § 39.130A-1. A modification of an option includes any material change in the terms or conditions of the option. For example, a material change in the terms of the option with respect to the kind or price of the shares of stock subject to the option is a modification of the option. Likewise, a material change in the time of issuance of stock subject to the option, the terms of payment for such stock, or an acceleration or postponement of the exercise date is a modification of the option. However, a mere change in the terms of the option, with respect to the number or price of the shares of stock subject to the option, to reflect a stock dividend or stock split-up is not a modification of the option. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares. An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The foregoing rules apply as well to successive modifications, extensions, and renewals.

(c) A restricted stock option may, as a result of a modification, extension, or renewal, thereafter cease to be a restricted stock option, or an option may, by modification, extension, or renewal, thereafter become a restricted stock option.

(d) The rule stated in section 130A (e) may be illustrated by the following examples:

Example (1). On June 1, 1952, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $90 per share, such option to be exercised on or before June 1, 1954. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1953, before the employee exercises the option, X Corporation modifies the option to provide that the price at which the employee may purchase the stock shall be $80 per share. On February 1, 1953, the fair market value of the X Corporation stock is $90 per share. Under section 130A (e), the X Corporation is deemed to have granted an option to the employee on February 1, 1953, to purchase at $80 per share 100 shares of stock having a fair market value of $100 per share, that is, the higher of the fair market value of the stock on June 1, 1952, and on February 1, 1953. The exercise of such option by the employee after February 1, 1953, is not the exercise of a restricted stock option.

Example (2). On June 1, 1952, the X Corporation grants to an employee a restricted stock option to purchase 100 shares of X Corporation stock at $90 per share, exercisable after December 31, 1953, and on or before June 1, 1954. On June 1, 1952, the fair market value of X Corporation's stock is $100 per share. On February 1, 1953, X Corporation modifies the option to provide that the option shall be exercisable on or after February 1, 1953, and on or before June 1, 1954. On February 1, 1953, the fair market value of X Corporation stock is $110 per share. Under section 130A (e), X Corporation is deemed to have granted an option to the employee on February 1, 1953, to purchase at $90 per share 100 shares of stock having a fair market value of $110 per share, that is, the higher of the fair market value of the stock on June 1, 1952, and on February 1, 1953. The exercise of such option by the employee is not the exercise of a restricted stock option.

Example (3). The facts are the same as in example (1), except that the employee exercised the option to the extent of 50 shares on January 15, 1953, prior to the date of the modification of the option. Any exercise of the option after February 1, 1953, the date of the modification, is not the exercise of a restricted stock option. See example (1) in this paragraph. The exercise of the option on January 15, 1953, pursuant to which 50 shares were acquired, is the exercise of a restricted stock option.

Example (4). On June 1, 1952, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $80 per share, such option to be exercised on or before June 1, 1954. At the time the option is granted the fair market value of the X Corporation stock is $100 per share. On February 1, 1953, before the employee exercises the option, the X Corporation modifies the option to provide that the number of shares of stock which the employee may purchase at $80 per share will be 250. On February 1, 1953, the fair market value of the X Corporation stock is $90 per share. Under these facts, the X Corporation has granted two options, one option (not a restricted stock option) with respect to 100 shares having been granted on June 1, 1952, and the other option (a restricted stock option) with respect to the additional 150 shares having been granted on February 1, 1953. In the absence of facts identifying which option is exercised first, the employee will be deemed to have exercised the options in the order in which they were granted.

§ 39.130A-5 *Operation of section 130A*—(a) *Rules applicable to all restricted stock options*—(1) *In general.* If a share of stock is transferred to an individual pursuant to his timely exercise of a restricted stock option and is not disposed of by him within two years from the date of the granting of the option nor within six months after the transfer of such share to him, then, under section 130A (a)—

(i) No income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(ii) No deduction under section 23 (a) shall be allowable at any time to the employer corporation of such individual or its parent or subsidiary corporation with respect to the share so transferred; and

(iii) No amount other than the option price shall be considered as received by either of such corporations for the share so transferred.

For the purpose of subdivisions (i) to (iii) of this subparagraph, each share of stock transferred pursuant to a restricted stock option is treated separately. For example, if an individual, while employed by a corporation granting him a restricted stock option, exercises the option with respect to part of the stock covered by the option, and if such individual exercises the balance of the option more than 3 months after leaving such employment, the application of section 130A to the stock obtained upon the earlier exercise of the option is not affected by the fact that the income taxes of the employer and the individual with respect to the stock obtained upon the later exercise of the option are not determined under section 130A.

(2) *Holding period.* The special rules provided in section 130A (a) are not applicable if the individual disposes of the share of stock within two years from the date the option is granted or within six months after the transfer of such share to him. Section 130A is not made inapplicable by a transfer within the 2-year or 6-month period if such transfer is not a disposition of the stock as defined in subparagraph (3) of this paragraph, for example, a transfer from the decedent to his estate or a transfer by bequest or inheritance. Similarly, a disposition by the executor, administrator, heir, or legatee is not a disposition by the decedent.

(3) *Disposition of stock.* (i) For the purpose of section 130A, the term "disposition" includes a sale, exchange, gift, or any transfer of legal title, but does not include a transfer from a decedent to his estate or a transfer by bequest or inheritance, an exchange which is within the provisions of section 112 (b) (2) or (3) or a mere pledge or hypothecation. However, a disposition of the stock pursuant to a pledge or hypothecation is a disposition by the individual, even though the making of the pledge or hypothecation is not such a disposition.

(ii) If an individual exercises a restricted stock option, a share of stock acquired pursuant to such exercise is not considered disposed of by the individual if such share is taken in the name of the individual and another person jointly with right of survivorship, or is subsequently transferred into such joint ownership, or is retransferred from such joint ownership to the sole ownership of the individual. However, if such individual and his joint owner transfer such share to another person, the individual has made a disposition of such share. Likewise, if a share of stock held in the joint names of such individual and another person is transferred to the name of such other person, there is a disposition of such share by the individual. If an individual exercises a restricted stock option and a share of stock is transferred to another or is transferred to such individual in his name as trustee for another, the individual has made a disposition of such share.

(4) *Examples.* The rules of section 130A (a) may be illustrated by the following examples:

Example (1). On June 1, 1952, the X Corporation grants to E, an employee, a restricted stock option to purchase 100 shares of X Corporation stock at $95 per share. On that date, the fair market value of X Corporation stock is $100 per share. On June 1, 1953, while employed by X Corporation, E exercises the option in full and pays X Corporation $9,500, and on that day X Corporation transfers to E 100 shares of its stock having a fair market value of $12,000. Prior to June 1, 1954, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 1953, with respect to the transfer to him of the 100 shares of X Corporation stock. X Corporation is not entitled to any deduction at any time with respect to its transfer to E of the stock. In computing its gain or loss, if any, upon such transfer, X Corporation is considered to have received no more than $9,500 for the stock so transferred. E's basis for such 100 shares is $9,500.

Example (2). Assume, in example (1), that on August 1, 1954, two years and one month after the granting of the option and one year and one month after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000, which is the fair market value of the stock on that date. For the taxable year in which the sale occurs, E realizes a gain of $3,500 ($13,000 minus E's basis of $9,500), which is treated as long-term capital gain.

Example (3). Assume, in example (2), that on August 1, 1954, E makes a gift of the 100 shares of X Corporation stock to his son. Such disposition results in no realization of gain to E either for the taxable year in which the option is exercised or the taxable year in which the gift is made. E's basis of $9,500 becomes the donee's basis for determining gain or loss.

Example (4). Assume, in example (1), that on May 1, 1954, one year and 11 months after the granting of the option and 11 months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000. The special rules of section 130A (a) are not applicable to the transfer of the stock by X Corporation to E, because disposition of the stock was made by E within two years from the date the option was granted.

Example (5). Assume, in example (1), that E dies on September 1, 1953, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 1953, of the restricted stock option. On the date of death, the fair market value of the stock is $12,500. No income is realized by E by reason of the transfer of the 100 shares to his estate. If E's executor elects to value the stock as of the date of death, the basis of the 100 shares in the hands of the executor is $12,500.

(b) *Additional rules applicable where the option price is between 85 percent and 95 percent of the value of the stock*—(1) *In general.* (i) If all the conditions necessary for the application of section 130A (a) exist, section 130A (b) provides additional rules which are applicable in cases where, at the time the restricted stock option is granted, the option price per share is less than 95 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and the 6-month periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods) there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) the amount, if any, by which the option price is exceeded by the lesser of the fair market value of the share at the time the option was granted or the fair market value of the share at the time of such disposition or death. The amount of such compensation shall be included in the individual's gross income for the taxable year in which the disposition occurs or for the taxable year closing with his death, whichever event results in the application of section 130A (b)

(ii) The application of the special rules provided in section 130A (b) shall not affect the rules provided in section 130A (a) with respect to the individual exercising the option, the employer corporation, or its parent or subsidiary corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 130A (b) no income results to the individual at the time the stock is transferred to him, and no deduction under section 23 (a) is allowable at any time to the employer corporation or its parent or subsidiary with respect to such amount. Likewise, for the purpose of determining gain or loss, if any, realized by any of such corporations by reason of the transfer of a share of stock with respect to which the rules of section 130A (b) apply, no amount other than the option price shall be considered as received by any of such corporations for the stock so transferred.

(iii) If the individual exercises a restricted stock option during his lifetime and dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of section 130A, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) *Basis.* If the special rules provided in section 130A (b) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 113, shall be increased by an amount

equal to the amount includible as compensation in his gross income under section 130A (b) If the special rules provided in section 130A (b) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 113, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross income under section 130A (b) See example (8) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) *Examples.* The operation of section 130A (b) may be illustrated by the following examples:

Example (1). On June 1, 1952, the X Corporation grants to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date is $100 per share. On June 1, 1953, E exercises the restricted stock option and on that date the X Corporation transfers the share of stock to E. On January 1, 1955, E sells the share for $150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporation are as follows: (i) Compensation in the amount of $15 is includible in E's gross income for 1955, the year of the disposition of the share. The $15 represents the difference between the option price ($85) and the fair market value of the share on the date the option was granted ($100), since such value is less than the fair market value of the share on the date of disposition ($150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100. Since the share was sold for $150, E realizes a gain of $50, which is treated as long-term capital gain; (ii) the X Corporation is entitled to no deduction under section 23 (a) at any time with respect to the share transferred to E. For the purpose of computing gain or loss, if any, to the X Corporation on account of the transfer of the share to E, the X Corporation shall not be considered to have received any amount other than $85 for the share.

Example (2). Assume, in example (1), that E sells the share of X Corporation stock on January 1, 1956, for $75, its fair market value on that date. Since $75 is less than the option price ($85), no amount in respect of the sale is includible as compensation in E's gross income for 1956. E's basis for determining gain or loss on the sale is $85. Since E sold the share for $75, E realized a loss of $10 on the sale, which loss is treated as a long-term capital loss.

Example (3). Assume, in example (1), that instead of selling the share on January 1, 1955, E makes a gift of the share on that day. In such case, $15 is includible as compensation in E's gross income for 1955. E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

Example (4). Assume, in example (2), that instead of selling the share on January 1, 1956, E makes a gift of the share on that date. Since the fair market value of the share on that day ($75) is less than the option price ($85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1956. E's basis for the share is $85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 113 (a) (2), is $75 (fair market value of the share at the date of gift).

Example (5). Assume, in example (1), that after acquiring the share of stock on June 1, 1953, E dies on August 1, 1954, at which time the share has a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death, such $15 being the difference between the option price ($85) and the fair market value of the share when the option was granted ($100), since such value is less than the fair market value at date of death ($150). The basis of the share in the hands of E's estate is determined under section 113 (a) (5) without regard to the $15 includible in the decedent's gross income.

Example (6). Assume, in example (5), that E dies on August 1, 1953, at which time the share has a fair market value of $150. Although E's death occurred within two years from the date of the granting of the option and within six months after the transfer of the share to him, the income tax consequences are the same as in example (5).

Example (7). Assume the same facts as in example (1) except that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and except that E and his wife sold the share on June 15, 1954, for $150, its fair market value on that date. Compensation in the amount of $15 is includible in E's gross income for 1954, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is $100, that is, the cost of $85 increased by the amount of $15 includible as compensation in E's gross income. The gain of $50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

Example (8). Assume the same facts as in example (1), except that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and except that E predeceased his wife on August 1, 1954, at which time the share had a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death. See example (5). The basis of the share in the hands of E's wife as survivor is, under sections 113 (a) and 130A (b), the cost of $85 increased by the $15 includible in the decedent's gross income or $100.

Example (9). Assume in example (8) that E's wife predeceased him on July 1, 1954. Section 130A (b) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1954, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (5). If E had sold the share on July 15, 1954 (after the death of his wife), for $150, its fair market value at that time, the income tax consequences would be the same as in example (1).

(c) *Acquisition of other stock or securities.* (1) Section 130A (c) provides that the special rules stated in section 130A (a) and (b) if applicable with respect to stock transferred to an individual upon his exercise of an option, shall likewise be applicable with respect to (i) stock or securities acquired by such individual in exchange for such stock, if the exchange is within the provisions of section 112 (b) (2) or (3) and (ii) new stock, as described in section 113 (a) (19) acquired upon a distribution with respect to such stock. Such new stock and such stock or securities so acquired shall, for the purpose of section 130A, be considered as having been transferred to the individual upon his exercise of the option. A similar rule shall be applied in the case of a series of such exchanges or acquisitions.

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

Example. If new stock, as described in section 113 (a) (19), is acquired upon a distribution with respect to stock transferred to the individual upon the timely exercise of a restricted stock option, and if such new stock is disposed of within two years from the date the option was granted or within six months after the original stock was transferred to such individual, section 130A is not applicable with respect to such new stock. If the disposition occurs after the 2-year and 6-month periods, section 130A is applicable.

SUPPLEMENT C—CREDITS AGAINST TAX

§ 39.131 (a) *Statutory provisions; taxes of foreign countries and possessions of United States; allowance of credit.*

SEC. 131. *Taxes of foreign countries and possessions of United States*—(a) *Allowance of credit.* If the taxpayer chooses to have the benefits of this section, the tax imposed by this chapter, except the tax imposed under section 102 and except the additional tax imposed for the taxable year under the provisions of section 127 (c) (3) and except the tax imposed under subchapter E and except, with respect to the tax imposed under subchapter D, only to the extent provided in subsection (j), shall be credited with:

(1) *Citizens and domestic corporations.* 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 the United States or Puerto Rico.* In the case of a resident of the United States and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, 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 the United States or Puerto Rico.* In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, 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.

Such choice may be made or changed at any time prior to the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter.

[Subsec. (a) as amended by sec. 216 (a), Rev. Act 1939; sec. 158 (a), Rev. Act 1942; sec.

6 (b) (4), Individual Income Tax Act 1944; sec. 208 (d) (3), Social Security Act Amendments 1950; sec. 221 (h), Rev. Act 1950; sec. 302 (a), Excess Profits Tax Act 1950; sec. 341 (c), Rev. Act 1951]

§ 39.131 (a)-1 *Analysis of credit for taxes.* (a) If the taxpayer chooses 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: (1) 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) 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.

(b) In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year who chooses to claim a credit for the taxes referred to in paragraph (a) of this section, the basis of the credit is as follows: (1) The amount of any such taxes paid or accrued during the taxable year to any possession of the United States; (2) 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 (3) 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.

(c) If a taxpayer chooses 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.

(d) The choice available to the taxpayer with respect to claiming such credit may be exercised (or changed if previously exercised) by the taxpayer at any time before the expiration of the period prescribed by statute for the making of a claim for credit or refund for the taxable year. For disallowance as a deduction of foreign income, war-profits, or excess-profits taxes in the event such choice is made, see § 39.23 (c)-1.

(e) In the case of a husband and wife making a joint return, credit for taxes paid or accrued to any foreign country or to any possession of the United States shall be computed upon the basis of the total taxes so paid by or accrued against the spouses.

(f) No credit for taxes shall be allowed against the tax imposed under section 102 (relating to surtax on corporations improperly accumulating surplus) against the additional tax imposed under the provisions of section 127 (c) (3) (relating to war loss recoveries), or against the tax on self-employment income imposed by section 480. Credit for taxes shall be allowed against the excess profits tax imposed by subchapter D of chapter 1, but only to the extent provided in section 131 (j) and § 39.131 (j)-1.

(g) 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.

§ 39.131 (a)-2 *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.

§ 39.131 (b) *Statutory provisions; taxes of foreign countries and possessions of United States; limit on credit.*

SEC. 131. *Taxes of foreign countries and possessions of United States.* * * *

(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, in the case of a taxpayer other than a corporation, 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, or in the case of a corporation, the same proportion of the tax against which such credit is taken, which the taxpayer's normal-tax net income from sources within such country bears to its entire normal-tax net income for the same taxable year; and

(2) The total amount of the credit shall not exceed, in the case of a taxpayer other than a corporation, 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, or, in the case of a corporation, the same proportion of the tax against which such credit is taken, which the taxpayer's normal-tax net income from sources without the United States bears to its entire normal-tax net income for the same taxable year; and

(3) [Repealed].

[Subsec. (b) as amended by sec. 216 (b), Rev. Act 1939; sec. 158 (d), Rev. Act 1942; sec. 130 (a), Rev. Act 1943; sec. 122 (g) (6), Rev. Act, 1945]

§ 39.131 (b)-1 *Limitations on credit for foreign taxes.* (a) 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, or, in the case of a corporation, which the taxpayer's normal-tax net income from sources within such country or possession bears to its entire normal-tax net income, for the same taxable year, is the tentative credit for the purpose of the income tax 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, or, in the case of a corporation, which the taxpayer's normal-tax net income from sources without the United States bears to its entire normal-tax net income, for the same taxable year, is the amount allowable as a credit against the income tax under chapter 1 for income or profits taxes paid or accrued to foreign countries or possessions of the United States. There must be excluded, in computing the tax against which the credit is taken, the tax imposed by section 102, the additional tax imposed for the taxable year under the provisions of section 127 (c) (3), the tax imposed by section 480, and, except to the extent provided in section 131 (j) and § 39.131 (j)-1, the excess profits tax imposed by subchapter D of chapter 1.

(b) The operation of the limitations on the credit for foreign taxes paid by individuals may be illustrated by the following examples:

Example (1). In 1952, 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 credit under section 25 for both normal tax and surtax of $600. The credit for foreign taxes allowable to A in his return for the calendar year 1952 is $16,089.33, 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 $74,400 ($75,000 less $600)	48,268.00
British income and profits taxes	18,000.00

Limitation on British income and profits taxes under section 131 (b) (1) and (2) to determine credit $\left(\frac{25,000}{75,000} \text{ of } \$48,268\right)$ $16,089.33

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)) 16,089.33

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 $10,800 and $4,500, respectively, the credit for foreign taxes allowable to A would be $14,153.60, 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 $74,400 ($75,000 less $600)	48,268.00
British income and profits taxes	10,800.00
Limitation on British income and profits taxes under section 131 (b) (1) to determine tentative credit $\left(\frac{15,000}{75,000} \text{ of } \$48,268\right)$	9,653.60
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))	9,653.60
Canadian income and profits taxes	4,500.00
Limitation on Canadian income and profits taxes under section 131 (b) (1) to determine tentative credit $\left(\frac{10,000}{75,000} \text{ of } \$48,268\right)$	6,435.73
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))	4,500.00
Sum of tentative credits ($9,653.60 plus $4,500)	14,153.60
Limitation on sum of tentative credits under section 131 (b) (2) to determine credit $\left(\frac{25,000}{75,000} \text{ of } \$48,268\right)$	16,089.33
Total amount of credit allowable (sum of tentative credits, since such sum is within the limitation under section 131 (b) (2))	14,153.60

(c) In the case of a husband and wife making a joint return, the limitations prescribed by section 131 (b) upon the credit for taxes paid or accrued to any foreign country or to any possession of the United States shall be applied with respect to the aggregate net income from sources within each such country or possession, the aggregate net income from all sources without the United States, and the aggregate net income from all sources, of the spouses.

(d) It is provided in section 131 (b) that in the case of a domestic corporation the amount of the credit for any taxable year with respect to the tax paid or accrued to any foreign country or possession of the United States shall not exceed the same proportion of the tax imposed by chapter 1 which the corporation's normal-tax net income from sources within such foreign country or possession of the United States bears to the entire normal-tax net income of such corporation for the same taxable year. The total amount of the credit shall not exceed the same proportion of the tax imposed by chapter 1 which the corporation's normal-tax net income from sources without the United States bears to the entire normal-tax net income for the same taxable year.

(e) The operation of the limitations provided in section 131 (b) on the credit for foreign taxes paid by corporations may be illustrated by the following example:

Example. The following facts exist for the calendar year 1952 with respect to the A Corporation which makes its income tax returns on the calendar year basis:

Net income from all sources	$250,000
Normal-tax net income	250,000
Net income from foreign country X	100,000
Foreign tax paid on country X income	60,000
Total normal tax and surtax	124,500
Computation of foreign tax credit for purposes of normal tax and surtax: $\frac{\$100,000}{\$250,000} \times \$124,500$	49,800
Amount allowable as a credit	49,800

(f) In the event that normal-tax net income is derived from more than one foreign country or possession of the United States, the limitation provided in section 131 (b) (2) shall be applied based upon the taxpayer's normal-tax net income from sources without the United States and the entire normal-tax net income of the corporation and such limitation is in addition to the limitation provided in section 131 (b) (1)

(g) The application of paragraph (f) of this section may be illustrated by the following example:

Example. (1) The net income for the calendar year 1952 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 are as follows:

Country	Net income	Loss	Income and profits taxes (paid or accrued)
United States	$157,500		
Great Britain	30,000		$17,000
Canada	20,000		12,000
Brazil	40,000		5,800
Nicaragua	60,000		None
Mexico		$100,000	None
Puerto Rico	10,000		2,250
France (dividend)	50,000		19,000
France (branch)	20,000		11,000

Net income		$387,500
Less: United States bond interest exempt from normal tax		25,000
Normal-tax net income		362,500
Surtax net income		387,500
Total foreign net income		230,000
United States tax (not including tax imposed under section 102):		
Normal tax	$108,750	
Surtax	79,750	
		188,500

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.

(2) The credit is $70,450 computed as follows:

Great Britain

Income and profits taxes paid or accrued	$17,000
Limitation under section 131 (b) (1) $\frac{30,000}{362,500} \times \$188,500$	15,600
Tentative credit	15,600

Canada

Income and profits taxes paid or accrued	12,000
Limitation under section 131 (b) (1) $\frac{20,000}{362,500} \times \$188,500$	10,400
Tentative credit	10,400

Brazil

Income and profits taxes paid or accrued	5,800
Limitation under section 131 (b) (1) $\frac{40,000}{362,500} \times \$188,500$	20,800
Tentative credit	5,800

Nicaragua

Tentative credit	None

Mexico

Tentative credit	None

Puerto Rico

Income and profits taxes paid or accrued	2,250
Limitation under section 131 (b) (1) $\frac{10,000}{362,500} \times \$188,500$	5,200
Tentative credit	2,250

France

Dividend tax paid at source		19,000
Income and profits taxes paid or accrued on branch operations		11,000
Income and profits taxes deemed under section 131 (f) to have been paid, computed as follows:		
Dividend received on Dec. 31 of the taxable year	$50,000	
Income of French corporation earned during taxable year	200,000	
Income and profits taxes paid to France on $200,000	30,000	
Accumulated profits ($200,000 minus $30,000)	170,000	
French taxes applicable to accumulated profits distributed: $\frac{50,000}{170,000} \text{ of } \frac{170,000}{200,000} \text{ of } \$30,000$		7,500
Total income and profits taxes paid or accrued and deemed to have been paid to France		37,500
Limitation under section 131 (b) (1) $\frac{70,000}{362,500} \times \$188,500$		36,400
Tentative credit		36,400

Sum of tentative credits

Great Britain	15,600
Canada	10,400
Brazil	5,800
Puerto Rico	2,250
France	36,400
	70,450
Limitation on sum of tentative credits under section 131 (b) (2) to determine credit: $\frac{230,000}{362,500}\times\$188,500$	119,600
Total amount of credit allowable (sum of tentative credits or the limitation under section 131 (b) (2), whichever is the lesser)	70,450

(h) As to the allowance of credit for foreign income, war-profits, or excess-profits taxes against the excess-profits tax imposed by subchapter D of chapter 1, see section 131 (j) and § 39.131 (j)-1.

§ 39.131 (c) *Statutory provisions; taxes of foreign countries and possessions of United States; adjustments on payment of accrued taxes.*

SEC. 131. *Taxes of foreign countries and possessions of United States.* * * *

(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. In such redetermination by the Commissioner of the amount of tax due from the taxpayer for the year or years affected by a refund, the amount of the taxes refunded for which credit has been allowed under this section shall be reduced by the amount of any tax described in subsection (a) imposed by the foreign country or possession of the United States with respect to such refund; but no credit under this section, and no deduction under section 23, shall be allowed for any taxable year with respect to such tax imposed on the refund. No interest shall be assessed or collected on any amount of tax due upon any redetermination by the Commissioner, resulting from a refund to the taxpayer, for any period prior to the receipt of such refund except to the extent interest was paid by the foreign country or possession of the United States on such refund for such period.

[Subsec. (c) as amended by sec. 2 (a), Pub. Law 378 (81st Cong.)]

§ 39.131 (c)-1 *Redetermination of tax when credit proves incorrect*—(a) *In general.* 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 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 district director of internal revenue. 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.

(b) *Foreign tax imposed on foreign refund.* Where the redetermination of the tax for a taxable year, or years, is occasioned by the refund to the taxpayer of tax paid to a foreign country or possession of the United States, the amount of such refund for which credit has been allowed shall be reduced by the amount of any tax described in section 131 (a) imposed by the foreign country or possession of the United States with respect to such refund. In such case no credit under section 131, and no deduction under section 23, shall be allowed with respect to such tax imposed on the refund.

(c) *Interest.* Where the redetermination of the tax for a taxable year, or years, is occasioned by the refund to the taxpayer of tax paid to a foreign country or possession of the United States, no interest shall be assessed or collected on the amount of tax due upon such redetermination resulting from such refund to the taxpayer, for any period before the receipt of such refund, except to the extent interest was paid by the foreign country or possession of the United States on such refund for such period.

§ 39.131 (c)-2 *Credit for taxes accrued but not paid.* 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 a 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 6 U. S. C. 15.

§ 39.131 (d) *Statutory provisions; taxes of foreign countries and possessions of United States; year in which credit taken.*

SEC. 131. *Taxes of foreign countries and possessions of United States.* * * *

(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.

§ 39.131 (d)-1 *When credit for taxes may be taken.* (a) 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 section 131 (d) 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, 1936, or 1938, 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.

(b) If, however, under the provisions of § 39.43-1 an amount otherwise constituting gross income for the taxable year from sources without the United States is, owing to monetary, exchange, or other restrictions imposed by a foreign country, not includible in gross income of the taxpayer for such year, the credit for income taxes imposed by such foreign country with respect to such amount shall be taken proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income.

§ 39.131 (e) *Statutory provisions; taxes of foreign countries and possessions of United States; proof of credits.*

SEC. 131. *Taxes of foreign countries and possessions of United States.* * * *

(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.

§ 39.131 (e)-1 *Conditions of allowance of credit.* (a) If the taxpayer does not signify in his return his desire to claim credit for income, war-profits, or excess-profits taxes paid other than to the United States, but subsequent to the filing of such return chooses to claim such credit, the taxpayer must so notify the Commissioner and attach to such notification Form 1116 in the case of an individual, and Form 1118 in the case of a corporation. The form must be carefully

filled in with all the information called for and with the calculations of credits indicated, and must be signed and contain or be verified by a written declaration that it is made under the penalties of perjury. Except where it is established to the satisfaction of the Commissioner that it is impossible for the taxpayer to furnish such evidence, the form must have attached to it (1) the receipt for each such tax payment if credit is sought for taxes already paid or (2) the return on which each such accrued tax was based if credit is sought for taxes accrued. 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.

(b) Where it has been established to the satisfaction of the Commissioner that it is impossible to furnish (1) a receipt for such foreign tax payment, (2) the foreign tax return, or (3) direct evidence of the amount of tax withheld at the source, the Commissioner may, in his discretion and under such rules as he may prescribe, accept secondary evidence of the payment or accrual of the tax or of the withholding of the tax.

(c) For credit available to a domestic corporation with respect to taxes paid by a foreign corporation, see § 39.131 (f)-1. A claim for credit in such a case is also to be made on Form 1118. See § 39.131 (d)-1 with reference to the option granted by section 131 (d)

(d) The taxpayer may, with respect to a particular taxable year, claim the benefits of section 131 at any time before the expiration of the period prescribed for the making of claim for credit or refund of the tax imposed under chapter 1 for such taxable year.

§ 39.131 (f) *Statutory provisions; taxes of foreign countries and possessions of United States; taxes of foreign corporation.*

SEC. 131. *Taxes of foreign countries and possessions of United States.* * * *

(f) *Taxes of foreign corporation*—(1) *Treatment of taxes paid by foreign corporation.* For the purposes of this section, a domestic corporation which owns at least 10 per centum 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 or deemed to be 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. 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.

(2) *Foreign subsidiary of foreign corporation.* If such foreign corporation owns 50 per centum or more of the voting stock of another foreign corporation from which it receives dividends in any taxable year it shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid by such other foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of the corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits.

[Subsec. (f) as amended by sec. 216 (c), Rev. Act 1939; sec. 158 (e), Rev. Act 1942; sec. 130 (b), Rev. Act 1943; sec. 332, Rev. Act 1951]

§ 39.131 (f)-1 *Taxes of foreign corporation*—(a) *Domestic corporation owning stock of a foreign corporation.* In the case of a domestic corporation which owns at least 10 percent 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 by such domestic corporation, determined by taking the same proportion of any income, war-profits, and excess-profits taxes paid or accrued 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 any such dividends received bears to the amount of such accumulated profits. If dividends are received from more than one such foreign corporation, the limitation is to be computed separately for the dividends received from each. For other limitations upon the amount of credit available under section 131, see § 39.131 (b)-1. 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 such a foreign corporation are deemed to have been paid by the domestic corporation for purposes of credit only.

(b) *Foreign corporation owning stock of another foreign corporation.* If any foreign corporation coming within the scope of paragraph (a) of this section (hereinafter referred to as former corporation) owns 50 percent or more of the voting stock of another foreign corporation (hereinafter referred to as latter corporation) from which it receives dividends in any taxable year, it shall be deemed, for the purpose of determining the foreign taxes the former corporation has paid or accrued, to have paid that proportion of any income, war-profits, or excess-profits taxes paid or accrued by the latter corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits. Such tax so deemed to have been paid shall then be taken into consideration in determining the amount of income, war-profits, and excess-profits taxes paid or deemed to have been paid by the former corporation to any possession or foreign country upon or with respect to its own accumulated profits from which the dividends were paid by such former corporation to the domestic corporation.

(c) *Illustration of principles.* The application of the principles of this section in the determination of the amount of the foreign tax available as a basis for a credit to the domestic corporation may be illustrated by the following example:

Example. The A Company, a domestic corporation, owns a majority of the voting stock of the B Company, Ltd., a foreign corporation, which in turn owns all of the stock except qualifying shares of the C Company, Ltd., another foreign corporation. The accumulated profits of the B Company amount to $200,000 (including $25,000 dividend derived from the C Company) and the foreign income tax paid by the B Company with respect to such accumulated profits amounts to $60,000. The C Company has accumulated profits of $150,000 upon or with respect to which the foreign income, war-profits, and excess-profits taxes are $45,000. A dividend of $50,000 is paid in 1952 by the B Company to the A Company and in the same year a dividend of $25,000 is paid by the C Company to the B Company. The amount of the foreign income, war-profits, and excess-profits tax of the C Company deemed to have been paid by the B Company is $\frac{25,000}{150,000} \times \$45,000$, or $7,500. The proportion of the foreign income tax deemed to have been paid by the A Company with respect to the accumulated profits of the B Company from which the dividend of $50,000 was paid by the B Company to the A Company equals $\frac{50,000}{200,000} \times (\$60,000 + \$7,500)$ or $16,875.

§ 39.131 (g)-(h) *Statutory provisions; taxes of foreign countries and possessions of United States; corporations treated as foreign, credit for taxes in lieu of income, etc., taxes.*

SEC. 131. *Taxes of foreign countries and possessions of United States.* * * *

(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, 42 Stat. 849 (U. S. C., Title 15, c. 4), and entitled to the credit provided for in section 262.

(h) *Credit for taxes in lieu of income, etc., taxes.* For the purposes of this section and section 23 (c) (1), the term "income, war-profits, and excess-profits taxes" shall include a tax paid in lieu of a tax upon income, war-profits, or excess-profits otherwise generally imposed by any foreign country or by any possession of the United States.

[Subsec. (h) as added by sec. 158 (f), Rev. Act 1942]

§ 39.131 (h)-1 *Meaning of terms.* (a) The term "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.

(b) For the purposes of sections 131 and 23 (c) (1) (C) the term "income, war-profits, and excess-profits taxes" includes a tax imposed by statute or decree by a foreign country or by a possession of the United States if (1) such country or possession has in force a general income tax law, (2) the taxpayer claiming the credit would, in the absence of a specific provision applicable to such taxpayer, be subject to such general income tax, and (3) such general income tax is not imposed upon the taxpayer thus subject to such substituted tax. For example, the A Corporation does business in the X country, which imposes an income tax upon substantially a net income base. The ascertainment of net income, though not the determination of gross income, from sources in X country is found administratively difficult. The X country, by decree, provides that corporations circumstanced as was the A Corporation would, in lieu of the income tax at the rate of 20 percent otherwise payable, be subject to tax at the rate of 10 percent upon the amount of gross income from X country. In accordance with such decree, the A Corporation paid X country the sum of $25,000 in 1953 with respect to its tax liability to the X country for the year 1952. Such amount, subject to the applicable limitations, is available as a credit to the A Corporation as foreign income, war-profits, or excess-profits taxes against the United States tax liability for the year 1952.

(c) The term "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.

(d) The term "any possession of the United States" includes, among others, Puerto Rico and the Virgin Islands. But see section 251.

(e) As to the meaning of "sources," see section 119.

(f) For definitions generally, see section 3797 and the regulations thereunder.

§ 39.131 (i)-(j) *Statutory provisions; taxes of foreign countries and possessions of United States; tax withheld at source; tax imposed by subchapter D.*

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SEC. 131. *Taxes of foreign countries and possessions of United States.* * * *

(i) *Tax withheld at source.* For the purposes of this supplement the tax imposed by this chapter shall be the tax computed without regard to the credit provided in section 32 and section 35.

[Subsec. (i) as added by sec. 172 (d), Rev. Act 1942, and amended by sec. 6 (b) (5), Individual Income Tax Act 1944]

(j) *Tax imposed by subchapter D.* This section shall be applicable for purposes of the tax imposed by subchapter D, but the tax paid or accrued to any country shall be deemed to be the amount of such tax reduced by the amount of the credit allowed under this section with respect to such tax against the tax imposed by this chapter without regard to subchapter D. The amount of the credit taken under this subsection shall be subject to each of the following conditions:

(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 excess profits net income from sources within such country bears to its entire excess profits 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 excess profits net income from sources without the United States bears to its entire excess profits net income for the same taxable year.

[Subsec. (j) as added by sec. 302 (b), Excess Profits Tax Act 1950]

§ 39.131 (j)-1 *Credit against excess profits tax imposed by subchapter D.* (a) A domestic corporation is allowed a credit against the excess profits tax imposed by subchapter D of chapter 1 for 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. To the extent pertinent, the provisions of section 131 and the regulations promulgated thereunder are applicable for the purpose of claiming credit for taxes under this section, except that for such purpose the amount of income and profits taxes paid or accrued during the taxable year to any foreign country or possession shall be deemed to be the amount of such taxes actually paid or accrued reduced by the amount of such taxes allowed as a credit under section 131 against the tax imposed by chapter 1 without regard to the excess profits tax imposed by subchapter D. See § 39.131 (b)-1 as to the amount of such credit allowable and as to the computation of the tax against which such credit may be taken.

(b) The amount of the income and profits taxes (determined under paragraph (a) of this section) 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 (j) (1) so as not to exceed that proportion of the excess profits tax which the taxpayer's excess profits net income from sources within such country or possession bears to its entire excess profits net income for the same taxable year, is the tentative credit for the purpose of this section in respect of the taxes paid or accrued to such country or possession. The sum of these tentative credits, limited under section 131 (j) (2) so as not to exceed that proportion of the excess profits tax which the taxpayer's excess profits net income from sources without the United States bears to its entire excess profits net income for the same taxable year, is the amount allowable as a credit against the excess profits tax for income or profits taxes paid or accrued to foreign countries or possessions of the United States. For the determination of the excess profits net income, see §§ 40.433 (a)-1 and 40.433 (a)-2 of this chapter (Regulations 130) For the determination of the source of such net income, see section 119 and the regulations thereunder.

(c) The application of this section may be illustrated by the following examples involving the calendar year 1952.

Example (1). In this example it is assumed that the taxpayer has no income or loss from any foreign country other than Country X. Accordingly, the limitation under section 131 (j) (2) will not change the credit determined after applying section 131 (j) (1).

(A) Normal tax net income from all sources	$100,000
(B) Total normal tax and surtax (before section 131 credit)	46,500
(C) Normal tax net income from foreign Country X	90,000
(D) Foreign tax paid on Country X income	49,500
(E) Limitation on foreign tax under section 131 (b) (1) and (2) to determine section 131 (a) credit allowable against normal tax and surtax: $\frac{\$90,000}{\$100,000} \times \$46,500$	41,850
(F) Foreign tax credit allowable against normal tax and surtax (foreign tax, but not in excess of above limitation of $41,850	41,850
(G) Excess profits net income from all sources	80,000
(H) Excess profits net income from foreign Country X	75,000
(I) Excess profits credit	60,000
(J) Excess profits tax (before section 131 credit)	6,000
(K) Foreign tax paid on Country X income for the purpose of section 131 (j) $49,500−$41,850	7,650
(L) Limitation on foreign tax under section 131 (j) (1) and (2) to determine section 131 (j) credit allowable against excess profits tax: $\frac{\$75,000}{\$80,000} \times \$6,000$	5,625
(M) Foreign tax credit allowable against excess profits tax (foreign tax for purpose of section 131 (j), but not in excess of above limitation of $5,625)	5,625
(N) Total income and excess profits tax (before section 131 credit) $46,500+$6,000	52,500
(O) Total credit under section 131. $41,850+$5,625	47,475
(P) Total income and excess profits tax after credit under section 131: $52,500—$47,475	5,025

Example (2). The facts are assumed to be the same as those under example (1), except that there is a net loss of $10,000 allocable to foreign country Y, which net loss was taken into account in determining the normal tax net income from all sources of $100,000 (item (A), example (1)) and the excess profits net income from all sources of $80,000 (item (G), example (1)). The total income and excess profits tax after credit under section 131 is computed as follows:

(A) Tentative foreign tax credit under section 131 (b) (1) allowable against normal tax and surtax (foreign tax paid on country X income, but not in excess of limitation under section 131 (b) (1)) $\frac{\$90,000}{\$100,000}\times\$46,500$	$41,850
(B) Limitation on foreign tax under section 131 (b) (2) to determine section 131 (a) credit allowable against normal tax and surtax: $\frac{\$80,000}{\$100,000}\times\$46,500$	37,200
(C) Foreign tax credit allowable against normal tax and surtax (tentative credit under section 131 (b) (1), but not in excess of $37,200 limitation under section 131 (b) (2))	37,200
(D) Foreign tax paid for the purpose of section 131 (j) $49,500−$37,200	12,300
(E) Tentative foreign tax credit under section 131 (j) (1) allowable against excess profits tax (foreign tax for purpose of section 131 (j), but not in excess of limitation under section 131 (j) (1)) $\frac{\$75,000}{\$80,000}\times\$6,000$	5,625
(F) Limitation on foreign tax under section 131 (j) (2) to determine section 131 (j) credit allowable against excess profits tax: $\frac{\$65,000}{\$80,000}\times\$6,000$	4,875
(G) Foreign tax credit allowable against excess profits tax (tentative credit under section 131 (j) (1), but not in excess of $4,875, limitation under section 131 (j) (2))	4,875
(H) Total income and excess profits tax (before section 131 credit) $46,500+$6,000	52,500
(I) Total credit under section 131. $37,200+$4,875	42,075
(J) Total income and excess profits tax after credit under section 131. $52,500−$42,075	10,425

SUPPLEMENT D—RETURNS AND PAYMENT OF TAX

§ 39.141 *Statutory provisions; consolidated returns.*

SEC. 141. *Consolidated returns*—(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 corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under subsection (b) prior to the last day prescribed by law for the filing of such return. 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 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 returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income- and excess-profits-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

(c) *Computation and payment of tax.* In any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under subsection (b) prescribed prior to the last day prescribed by law for the filing of such return; except that the tax imposed under section 15 or section 204 shall be increased by 2 per centum of the consolidated corporation surtax net income of the affiliated group of includible corporations. If the affiliated group includes one or more Western Hemisphere trade corporations (as defined in section 109), the increase of 2 per centum provided in the preceding sentence shall be applied only on the amount by which the consolidated corporation surtax net income of the affiliated group exceeds the portion (if any) of the consolidated corporation surtax net income attributable to the Western Hemisphere trade corporations included in such group. For the purposes of the tax imposed by section 430, the sum of the excess profits credit and the unused excess profits credit adjustment of the affiliated group shall not be increased under the last sentence of section 431 to an amount in excess of $25,000 for the entire group.

(d) *Definition of "affiliated group"* As used in this section, an "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(e) *Definition of "includible corporation"* As used in this section, the term "includible corporation" means any corporation except—

(1) Corporations exempt from taxation under section 101.

(2) Insurance companies subject to taxation under section 201 or 207.

(3) Foreign corporations.

(4) Corporations entitled to the benefits of section 251, by reason of receiving a large percentage of their income from sources within possessions of the United States.

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

(6) Regulated investment companies subject to tax under Supplement Q.

(7) Any corporation described in section 449, or in section 454 (d), (f), and (g) (without regard to the exception in the initial clause of section 454), but not including such a corporation which has made and filed a consent, for the taxable year or any prior taxable year ending after June 30, 1950, to be treated as an includible corporation. Such consent shall be made and filed at such time and in such manner as may be prescribed by the Secretary.

(8) Regulated public utilities described in section 448 (d) which compute their excess profits credit under section 448 but not including any such regulated public utility which has made and filed a consent, applicable to the taxable year, to compute its excess profits credit without regard to section 448. The consent shall be made and filed at such time and in such manner as may be prescribed by the Secretary. The consent shall be applicable to the taxable year for which filed and to each consecutive subsequent taxable year for which a consolidated return is filed.

(f) *Includible insurance companies.* Despite the provisions of paragraph (2) of subsection (e), two or more domestic insurance companies each of which is subject to taxation under the same section of this chapter shall be considered as includible corporations for the purpose of the application of subsection (d) to such insurance companies alone.

(g) *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 chapter as a domestic corporation.

(h) *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.

(i) *Allocation of income and deductions.* For allocation of income and deductions of related trades or businesses, see section 45.

(j) *Includible regulated public utilities.* Despite the provisions of paragraph (8) of subsection (e), two or more regulated public utilities each of which has made and filed a consent, applicable to the taxable year, to compute its excess profits credit under section 448 only, shall be considered as includible corporations for the purpose of the application of subsection (d) to such regulated public utilities alone. The consent shall be made and filed at such time and in such manner as may be prescribed by the Secretary. The consent shall be applicable to the taxable year for which filed and to each consecutive subsequent taxable year for which a consolidated return is filed.

[Sec. 141 as amended by sec. 159 (a), Rev. Act 1942; secs. 131 and 204 (c), Rev. Act 1943; sec. 2 (c), Tax Adjustment Act 1945; sec. 121 (f), Rev. Act 1950; sec. 301, Excess Profits Tax Act 1950]

§ 39.141-1 *Consolidated income and excess profits tax returns of affiliated corporations*—(a) *In general.* Section 141 prescribes rules for the making of consolidated income and excess profits tax returns by affiliated groups of corporations. Part 24 of this chapter (Regulations 129) is applicable to the making of the consolidated income and excess profits tax return in the case of a taxable year ending after December

31, 1949. The determination, computation, assessment, collection, and adjustment of income and excess profits tax liabilities of the affiliated group and each member thereof both during and after the period of affiliation shall be made under the applicable provisions of such regulations.

(b) *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, which is an includible corporation, becomes the owner directly of stock possessing at least 95 percent of the voting power of all classes of stock and at least 95 percent of each class of the nonvoting stock (not including nonvoting stock which is limited and preferred as to dividends) of another includible corporation. A corporation becomes a member of such an affiliated group at the time that one or more members of such group become the owners directly of stock possessing at least 95 percent of the voting power of all classes of its stock and at least 95 percent of each class of its nonvoting stock (not including nonvoting stock which is limited and preferred as to dividends) A corporation ceases to be a member of such an affiliated group at the time that the members of such group cease to own directly stock possessing at least 95 percent of the voting power of all classes of its stock, or at least 95 percent of each class of its nonvoting stock (not including nonvoting stock which is limited and preferred as to dividends)

(c) *Corporations to be included in consolidated returns.* (1) The privilege of filing consolidated returns is extended to all includible corporations constituting an "affiliated group" as defined in section 141 (d) In case a corporation is a member of an affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for the part of the year during which it is a member of the group. An "includible corporation" is defined by section 141 (e) to mean any corporation except—

(i) A corporation exempt under section 101 from the tax imposed by chapter 1,

(ii) An insurance company subject to taxation under section 201 or 207 (except as provided in section 141 (f))

(iii) A foreign corporation (except as provided in section 141 (g))

(iv) A corporation entitled to the benefits of section 251, by reason of receiving a large percentage of its income from sources within possessions of the United States;

(v) A corporation organized under the China Trade Act, 1922 (15 U. S. C., c. 4)

(vi) A regulated investment company subject to tax under Supplement Q (sections 361 and 362)

(vii) A personal service corporation described in section 449 or a corporation described in section 454 (d), (f) or (g) which, without regard to the exception stated in the initial clause of section 454, would be exempt from the excess profits tax imposed by subchapter D of chapter 1, except as otherwise provided in section 141 (e) (7). As to the exception provided in section 141 (e) (7), see the provisions set forth in subparagraph (3) of this paragraph; and

(viii) A regulated public utility corporation described in section 448 (d), except as otherwise provided in section 141 (e) (8) and section 141 (j) As to the exception provided in section 141 (e) (8), see the provisions set forth in subparagraph (4) of this paragraph. As to the exception provided in section 141 (j) see paragraph (g) of this section.

(2) The corporations described in section 454 (d), (f) and (g), are personal holding companies as defined in section 501, certain domestic corporations which derive a specified part of their gross income from sources outside the United States (section 454 (f)), and certain corporations which receive compensation from the United States for the transportation of mail by aircraft (section 454 (g))

(3) Any corporation which otherwise would not be an includible corporation under subparagraph (1) (vii) of this paragraph and section 141 (e) (7) may make and file a consent to be treated as an includible corporation. A corporation which has made and filed a consent for any taxable year ending after June 30, 1950, shall be treated as an includible corporation for such taxable year and for each subsequent taxable year. With respect to the subsequent taxable years, such corporation shall be deemed to be an includible corporation regardless of whether the affiliated group of which such corporation is a member during the subsequent taxable year is the same as the affiliated group of which it was a member when the consent was filed. If such corporation is a common parent corporation, the making and filing of the consolidated income tax return shall constitute the making and filing of its consent under section 141 (e) (7) If such corporation is a subsidiary, the filing for a taxable year ending after June 30, 1950, of its authorization and consent on Form 1122 in the manner prescribed by § 24.12 (b) of this subchapter (Regulations 129) shall constitute the making and filing of such consent. A consent to be treated as an includible corporation under section 141 (e) (7) cannot be withdrawn or revoked at any time after the consolidated return is filed for the first taxable year for which the consent is filed, except as otherwise provided in section 613 of the Revenue Act of 1951. Section 613 of that Act relates to the withdrawal within 90 days after October 20, 1951 (the date of enactment of that act) of consents for the first taxable year ending after June 30, 1950, with respect to corporations described in section 454 (f)

(4) Under section 141 (e) (8), any regulated public utility corporation may make and file a consent to compute its excess profits credit without regard to section 448. A corporation which has made and filed such consent shall be treated as an includible corporation under section 141 (e) (8) for the taxable year for which such consent is filed and for each consecutive subsequent taxable year for which a consolidated return is made or is required to be made by the affiliated group of which it was a member at the time such consent was filed unless it has ceased to be a member of such group. If such corporation is a common parent corporation, the making and filing of a consolidated return in which the consolidated excess profits credit is determined under provisions other than those of section 448 shall constitute the making and filing of its consent under section 141 (e) (8). If such corporation is a subsidiary, the filing of an authorization and consent on Form 1122, in the manner prescribed by § 24.12 (b) of this subchapter (Regulations 129), indicating thereon its consent to compute its excess profits credit without regard to section 448 shall constitute the making and filing of such consent. A consent to be treated as an includible corporation under section 141 (e) (8) cannot be withdrawn or revoked at any time after the consolidated return is filed for the first taxable year for which the consent is filed; however, if a separate return is properly filed by such a corporation for a subsequent taxable year, it is not thereafter an includible corporation under section 141 (e) (8) unless another consent under such section is made and filed.

(5) The consolidated income and excess-profits tax return must include every includible corporation which, under the provisions of section 141, is a member of the affiliated group. In no case may a consolidated return be filed by subsidiary corporations as an affiliated group unless the common parent corporation through which the subsidiaries are connected is a member of the group. For instance, there will not be recognized as an affiliated group two domestic industrial corporations the common parent corporation of which is a regulated investment company subject to tax under Supplement Q. In addition, no corporation which is connected by stock ownership with an affiliated group of includible corporations through a nonincludible corporation may be included in the consolidated return of such group.

(6) Every corporation which is a member of an affiliated group making consolidated returns under section 141 is a member of such group, regardless of any exemption to which it might have been entitled if separate returns had been made. See sections 449 and 454.

(d) *Consolidated returns of insurance companies.* An insurance company subject to tax under section 204 is an includible corporation and may be included in an affiliated group together with corporations other than insurance companies taxable under section 201 or section 207. Insurance companies subject to tax under section 201 or 207 are not includible corporations under section 141 (e) (2). Under section 141 (f), however, a domestic insurance company taxable under section 201 may be included in an affiliated group comprised solely of other domestic insurance companies taxable under section 201; it may not be included in an affiliated group with other corpo-

rations. Similarly a domestic insurance company taxable under section 207 may be included in an affiliated group comprised solely of other domestic insurance companies taxable under section 207; it may not be included in an affiliated group with other corporations. An affiliated group of domestic insurance companies taxable under section 201, or a group of domestic insurance companies taxable under section 207, may not include a domestic insurance company taxable under section 204.

(e) *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 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 as a domestic corporation. The option to treat such foreign corporation as a domestic corporation must be exercised at the time of making the consolidated return, and cannot be exercised at any time thereafter. If the foreign corporation is included or is required to be included in the consolidated return of the affiliated group of which it is a member for any taxable year, it must be included in the consolidated return for each consecutive taxable year thereafter for which such group makes or is required to make a consolidated return.

(f) *Computation of tax.* The surtax imposed by section 15 or section 204 upon an affiliated group making a consolidated income tax return shall be increased by 2 percent of the consolidated corporation surtax net income. For example, if the consolidated corporation surtax net income of an affiliated group for a taxable year is $40,000, the increase in the surtax for such taxable year is $800, that is 2 percent of $40,000. If the affiliated group includes one or more Western Hemisphere trade corporations (as defined in section 109) the increase shall be applied in the manner provided in § 24.30 (b) (1) of this subchapter (Regulations 129)

(g) *Consolidated returns of regulated public utilities computing excess profits credit under section 448.* A regulated public utility which has made and filed a consent to compute its excess profits credit under section 448 only may be included in an affiliated group (within the meaning of section 141 (d)) comprised solely of regulated public utility corporations each of which has made and filed such a consent. If such consent of a regulated public utility corporation is filed for any taxable year ending after June 30, 1950, such corporation shall be an includible corporation within the meaning of section 141 (j) for the taxable year for which such consent is filed and for all consecutive subsequent taxable years for which such affiliated group of which such corporation is a member makes or is required to make a consolidated return. If such corporation is a common parent corporation, the making and filing of a consolidated return in which the consolidated excess profits credit is determined under the provisions of section 448 shall constitute the making and filing of its consent under section 141 (j) If such corporation is a subsidiary, the filing of its authorization and consent on Form 1122, in the manner prescribed by § 24.12 (b) of this subchapter (Regulations 129) indicating thereon its consent to compute its excess profits credit with respect to section 448 only, shall constitute the making and filing of such consent. A consent to be treated as an includible corporation under section 141 (j) cannot be withdrawn or revoked at any time after the consolidated return is filed for the first taxable year for which the consent is filed. However, if a separate return is properly filed by such a corporation for a subsequent taxable year, it is not thereafter an includible corporation under section 141 (j) unless another consent under such section is made and filed.

§ 39.142 *Statutory provisions; fiduciary returns.*

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 chapter and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner with the approval of the Secretary may by regulations prescribe—

(1) Every individual having a gross income for the taxable year of $600 or over;

(2) Every estate the gross income of which for the taxable year is $600 or over;

(3) Every trust the net income of which for the taxable year is $100 or over, or the gross income of which for the taxable year is $600 or over, regardless of the amount of net income;

(4) 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 chapter shall be subject to all the provisions of law which apply to individuals.

[Sec. 142 as amended by sec. 7 (b), Rev. Act 1940; sec. 112 (b), Rev. Act 1941; sec. 131 (c) (2), Rev. Act 1942; sec. 11 (c), Individual Income Tax Act 1944; sec. 202 (c), Rev. Act 1948]

§ 39.142–1 *Fiduciary returns.* (a) Every fiduciary, or at least one of joint fiduciaries, must make a return of income—

(1) *Returns for individuals.* For the individual whose income is in his charge, if the gross income of such individual is $600 or over. The return shall be on Form 1040.

(2) *Returns for estates and trusts.* For the estate for which he acts if the gross income of such estate is $600 or over, and for the trust for which he acts if the gross income of such trust is $600 or over, or the net income of such trust, as computed under section 162, is $100 or over, or if any beneficiary of such estate or trust is a nonresident alien. The return shall be on Form 1041.

(b) In cases in which the gross income of the estate or trust is $5,000 or over, a copy of the will or trust instrument, sworn to by the fiduciary as a true and complete copy 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, and statement relating to the provisions of the will or trust instrument, have once been filed, they need not again be filed if the fiduciary return contains a statement showing when and where they were filed. If the trust instrument is amended in any way after such copies have 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.

(c) See § 39.142–5 for returns in cases where any beneficiary is a nonresident alien. For returns on Form 990–T by certain trusts otherwise exempt from tax under section 101 (6), which trusts are subject to the tax imposed by section 421 (a) (2) upon Supplement U net income, see § 39.421–3. For information returns required to be made by fiduciaries under section 147, see § 39.147–1. As to further duties and liabilities of fiduciaries, see section 312.

§ 39.142–2 *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 gross income of $600 or more for the taxable year, must make a return for such person on Form 1040 and pay the tax unless, in the case of a minor, the minor himself makes a return or causes it to be made. As to the use of the optional return, see § 39.51–2.

§ 39.142–3 *Returns in case of 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.

§ 39.142-4 *Return by receiver* A receiver who stands in the place 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)

§ 39.142-5 *Return for nonresident alien beneficiary*—(a) *United States business.* 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 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 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 § 39.217-1.

(b) *No United States business.* 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 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 1040NB-a if a beneficiary has gross income for the taxable year of more than $15,400 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 $15,400 or less, the return (if a return is required to be filed) for the beneficiary shall be on Form 1040NB. If a return is required to be filed for a beneficiary who is a resident of Canada, such return also shall be on Form 1040NB. 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 on the entire amount of the income payable to the beneficiary. 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.

§ 39:142-6 *Time for filing return upon death, or termination of trust.* (a) Under the provisions of section 47 (g), the return by a taxpayer which was not in existence throughout a taxable period of 12 months is a return for the fractional part of a year during which the taxpayer was in existence. If a return is required under the provisions of §§ 39.47-1 and 39.142-1 for the last taxable year of a decedent, the executor or administrator of the decedent shall file such return at the time prescribed in § 39.53-1. If a return for the last taxable year of an estate or trust is required to be filed under the provisions of § 39.142-1, such return shall be filed at the time prescribed in § 39.53-1, and the last date prescribed for such filing 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)

(b) 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 district director of internal revenue for his internal revenue 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.

§ 39.143 *Statutory provisions; withholding of tax at source.*

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 chapter 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: *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) 30 per centum in the case of a nonresident alien individual (except that such rate shall be reduced, in the case of a resident of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, 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 composed in whole or in part of nonresident aliens, (B) in the case of such a foreign corporation, 30 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 30 per centum. As used in this subsection the term "nonresident alien individual" includes an alien resident of Puerto Rico.

(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 interest, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the exemptions 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 or obligor and obligee.* The obligor shall not be allowed a deduction for the payment of the tax imposed by this chapter, 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), dividends, rent, salaries, wages, premiums, annuities, compensations, renumerations, 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 composed in whole or in part of nonresident aliens, shall (except in the cases pro-

vided 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 30 per centum thereof, except that such rate shall be reduced, in the case of a nonresident alien individual a resident of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, 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, 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: *Provided further* That the deduction and withholding in the case of interest on bonds, mortgages, or deeds of trust or other similar obligations of a corporation, within the provisions of subsection (a) (1) of this section were it not for the fact that the maturity date of such obligations has been extended on or after January 1, 1934, and the liability assumed by the debtor exceeds 27½ per centum of the interest, shall not exceed the rate of 27½ per centum per annum. 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. In respect of the compensation for services performed by nonresident alien individuals brought into the United States under the authority of the War Manpower Commission for temporary employment essential to the war effort and subject to withholding under this subsection, the deduction and withholding shall be at the rate of 10 per centum, and there shall be no deduction or withholding under section 1622. As used in this subsection, the term "nonresident alien individual" includes an alien resident of Puerto Rico.

(c) *Return and payment.* Every person required to deduct and withhold any tax under this section shall, on or before March 15 of each year, make return thereof and pay the tax to the collector designated in section 53 (b). 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.

(g) *Cross reference.* For definition of "withholding agent," see section 3797 (a) (16).

(h) *Withholding on certain foreign tax-exempt organizations.* In the case of income of a foreign organization subject to the tax imposed by section 421 (a), the provisions of this section and section 144 shall apply to rents includible under section 422 in computing its unrelated business net income, but only to the extent and subject to such conditions as may be provided under regulations prescribed by the Secretary.

[Sec. 143 as amended by secs. 5 (a) and 202, Rev. Act 1940; secs. 107 and 109 (a), Rev. Act 1941; secs. 108 and 160 (a), Rev. Act 1942; sec. 132, Rev. Act 1943; sec. 10 (d), Individual Income Tax Act 1944; sec. 102 (b) (5), Rev. Act 1945; secs. 219, 221 (e), 301 (c) (4), Rev. Act 1950]

§ 39.143-1 *Withholding tax at source*—(a) *Withholding in general.* (1) Withholding of a tax of 30 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 to a nonresident partnership, composed in whole or in part of nonresident alien individuals, except—

(i) 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,

(ii) 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 section)

(iii) Dividends paid by a foreign corporation unless (*a*) such corporation is engaged in trade or business within the United States, 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, and

(iv) Dividends distributed by a corporation organized under the China Trade Act, 1922 (15 U. S. C., c. 4) to a resident of China.

Such rate of 30 percent shall be reduced as may be provided by treaty with any country. See section 22 (b) (7) Withholding is required in the case of interest paid on obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof. See §§ 39.22 (b) (4)-4 and 39.22 (b) (4)-6, relating to the taxation of such interest, and § 39.143-4, relating to ownership certificates.

(2) The rate of withholding provided with respect to compensation for services performed by a nonresident alien individual, or by a citizen of a possession of the United States not otherwise a citizen of the United States, brought into the United States under proper authority for temporary employment essential to the war effort shall be at the reduced rate of 10 percent. In applying such reduced rate of withholding, however, to the compensation of a nonresident alien or other individual coming within the scope of this subparagraph, the proration of the exemptions provided in § 39.143-3, is not applicable. The rate of 10 percent provided in this subparagraph should, therefore, be applied against the gross amount of the compensation derived from labor or personal services by such an individual. The provisions of this subparagraph shall not be construed as cancelling or affecting any exemption from withholding in the case of any nonresident alien individual under existing law, regulations, or ruling, nor do such provisions affect the tax liability of such a nonresident alien individual.

(3) Under the provisions of section 143 (b) the rate of tax withheld at the source shall not exceed 27½ percent in the case of interest on bonds, mortgages, or deeds of trust or other similar obligations of a corporation within the provisions of section 143 (a) (1) were it not for the fact that the maturity date of such obligations has been extended on or after January 1, 1934.

(4) 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.

(5) The tax need not be withheld on accrued interest paid in connection with the sale of bonds between interest dates.

(6) A tax of 30 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.

(7) The gross amount of rents paid under a Supplement U lease to an organization subject to the tax imposed by section 421 (a) with respect to rents includible under section 422 in computing unrelated business net income is subject to withholding.

(8) For withholding in the case of income paid to nonresident foreign corporations, see § 39.144-1.

(9) 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.

(10) 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.

(11) 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 Internal Revenue Code, is required to file notice of such appointment with the Commissioner of Internal Revenue, Washington 25, D. C., giving the name and address of the agent; except that, on and after July 19, 1953, such notice shall be filed with the District Director of Internal Revenue, Baltimore 2, Maryland.

(12) 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.

(13) For determining income from sources within the United States, see section 119.

(14) As to who are nonresident alien individuals, see §§ 39.211-2 and 39.3797-8. For the purpose of section 143 (a) (1) and (b) the term "nonresident alien individual" includes an alien resident of Puerto Rico. For classification of foreign corporations, see §§ 39.231-2 and 39.3797-8. As to what partnerships are deemed to be nonresident partnerships, see § 39.3797-8.

(15) For withholding in the case of dividends distributed by a corporation organized under the China Trade Act, 1922 (15 U. S. C., c. 4) see §§ 39.143-3 and 39.262-4.

(b) *Tax-free covenant bonds issued before January 1, 1934.* (1) 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.

(2) 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 by the regulation under section 143, 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.

(3) 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)

(4) 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 30 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.

(5) 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 § 39.144-1.

(6) 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 before January 1, 1934, by supplemental agreements containing a tax-free covenant executed by the obligor corporation and the trustee, the bonds issued before 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.

(7) 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 (i) the tax required to be withheld by the fiduciary from the income of nonresident alien beneficiaries and (ii) 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 someone 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.

§ 39.143-2 *Fixed or determinable annual or periodical income.* (a) Only fixed or determinable annual or periodical income is subject to withholding. The Internal Revenue Code 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.

(b) 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 fixed or determinable annual or periodical 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 pe-

riodical 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.

§ 39.143-3 *Exemption from withholding.* (a) Withholding from interest on bonds or other obligations of corporations issued before January 1, 1934, containing a tax-free covenant, shall not be required if there is filed with the withholding agent when presenting coupons for payment, or not later than February 1 of the following year, an ownership certificate on Form 1000 stating—

(1) In the case of a citizen or resident of the United States, that his net income does not exceed his exemptions under section 25 (b) or

(2) In the case of an estate or trust, that the net income does not exceed the credit allowed under section 163 (a) (1)

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, Washington 25, D. C., with a letter of transmittal; except that, on and after July 19, 1953, such certificates shall be forwarded to the District Director of Internal Revenue, Baltimore 2, Maryland.

(b) The income of domestic corporations and of resident foreign corporations is free from withholding.

(c) No withholding from dividends paid by a corporation organized under the China Trade Act, 1922 (15 U. S. C., c. 4) 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)

(d) The salary or other compensation for personal services of a nonresident alien individual who enters or leaves the United States at frequent intervals shall not be subject to deduction and withholding of income tax at the source if—

(1) Such nonresident alien is a resident of Canada or Mexico, or

(2) Such nonresident alien is engaged in agricultural labor as defined in section 1426 (h)

(e) A nonresident alien individual not engaged in trade or business within the United States 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 the exemptions under section 25 (b) A nonresident alien individual who is engaged in trade or business within the United States at any time during the taxable year is entitled to the exemption allowed by section 25 (b) (1) (A) If such nonresident alien is a resident of Canada or Mexico, he is also entitled to the exemptions allowed by section 25 (b) (1) (B) (C) or (D) The benefit of such exemptions may not be received by filing a claim therefor with the withholding agent. However, in the determination of the tax to be withheld at the source under section 143 (b) with respect to remuneration paid for labor or personal services performed within the United States by a nonresident alien, the benefit of the exemption for both normal tax and surtax shall be allowed, prorated upon a daily basis for the period of employment during any portion of which labor or personal services are performed within the United States by such alien. Such proration is on a basis of $1.70 per day. Thus, if A, a nonresident alien seaman employed by X Shipping Corporation, is paid in 1952 upon the termination of a voyage covering 100 days and A performs personal services within the United States during, or incident to such voyage, the amount of $170 will be allocated as the portion of the exemption to be allowed as a credit against the remuneration of A for personal services performed within the United States during such voyage, and withholding shall be applied against the balance, if any, of such remuneration. If, for example, the total remuneration paid to A for such voyage is $800, of which the amount of $120 is allocable to sources within the United States, there is no withholding. As to what constitutes remuneration for labor or personal services performed within the United States, see section 119 (a) (3) and § 39.119 (a)-3. The amount of the compensation allocable to labor or personal services performed within the United States together with the amount of the exemption for both normal tax and surtax, prorated as set forth above, shall be shown on the annual withholding return, Form 1042.

§ 39.143-4 *Ownership certificates for bond interest.* (a) 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, regardless of the amount of the coupons, for each issue of such obligations issued before January 1, 1934, and containing a tax-free covenant.

(b) 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.

(c) 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 in such cases 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. Ownership certificates (Form 1001) shall also be filed in the case of interest paid on obligations of the United States or any agency or instrumentality thereof, regardless of the date of issuance of such obligations, if such obligations are owned by the persons described in the first sentence of this paragraph.

(d) The ownership certificate shall show the name and address of the obligor, 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.

(e) 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 the obligations of possessions of the United States. 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.

(f) When interest coupons detached from corporate bonds, or from obligations of the United States or of any agency or instrumentality thereof, 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 quarterly return on Form 1012; except that, on and after July 19, 1953, such statement and return shall be forwarded to the District Director of Internal Revenue, Baltimore 2, Maryland. 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, and

shall stamp or write across the face of the certificate "Statement furnished," adding the name of the bank.

(g) 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.

§ 39.143-5 *Form of certificate for citizens or residents.* For the purpose of § 39.143-4, 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.

§ 39.143-6 *Form of certificate for nonresident aliens, nonresident foreign corporations, and unknown owners.* For the purpose of § 39.143-4, 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.

§ 39.143-7 *Return and payment of tax withheld.* (a) 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 and interest on obligations issued by the United States or any agency or instrumentality thereof on or after March 1, 1941. This return should be filed with the district director for the internal revenue district in which the withholding agent is located. The withholding agent also shall make a quarterly return on Form 1012 on or before the last day of the month following the termination of the quarter for which the return is made. The ownership certificates, Forms 1000 and 1001, must be forwarded to the Commissioner with the quarterly return; except that, on and after July 19, 1953, such certificates and return shall be forwarded to the District Director of Internal Revenue, Baltimore 2, Maryland. Forms 1001 should be listed on the quarterly return. While Forms 1000 need not be listed on the return, the number of such forms submitted and the total amount of interest paid and of the tax withheld on such of the forms as report interest from which the tax is to be withheld should be entered in the spaces provided. If Form 1000 is modified to show the name and address of a fiscal or paying agent in the United States (see § 39.143-5) Forms 1012 and 1013 should be likewise modified. In the case of interest on obligations of the United States or of any agency or instrumentality thereof the withholding agents shall be: (1) The Commissioner of the Public Debt for interest paid by checks issued through the Bureau of the Public Debt; (2) the Treasurer of the United States for all interest paid by him, whether by check or otherwise; and (3) each Federal reserve bank for all interest paid by it, whether by check or otherwise.

(b) Every person required to deduct and withhold any tax from income other than such bond interest shall make an annual return thereof to the district director of internal revenue for the internal revenue district in which such person is located 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. 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 quarterly returns on Form 1012, including items of interest where the liability for withholding is only 2 percent.

(c) In every case the tax withheld must be paid to the district director of internal revenue on or before March 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.

(d) 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 district director 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.

(e) 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.

§ 39.143-8 *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.

§ 39.143-9 *Return of income from which tax was withheld.* (a) 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, § 39.142-5. 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.

(b) 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 15 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.

§ 39.144 *Statutory provisions; payment of corporation income tax at source.*

SEC. 144. *Payment of corporation income tax at source.* In the case of foreign corporations subject to taxation under this chapter not engaged in trade or business within the United States, 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 30 per centum thereof, except that in the case of corporations organized under the laws of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, such rate 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.

[Sec. 144 as amended by sec. 5 (b), Rev. Act 1940; secs. 107 (a) and 109 (a), Rev. Act 1941; secs. 103 (a) and 160 (a) (3), Rev. Act 1942]

§ 39.144-1 *Withholding in the case of nonresident foreign corporations.* (a) A tax of 30 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 in-

terest on deposits with persons carrying on the banking business paid to such corporation, and (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. Such rate shall be reduced as may be provided by treaty with any country.

(b) Withholding is required in the case of interest paid on obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof. See §§ 39.22 (b) (4)-4 and 39.22 (b) (4)-6, relating to the taxation of such interest, and § 39.143-4, relating to ownership certificates.

(c) 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 before 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.

(d) A tax of 30 percent is required to be withheld from dividends (other than dividends distributed by a corporation organized under the China Trade Act, 1922 (15 U. S. C., c. 4) to a resident of China) from sources within the United States paid to a nonresident foreign corporation, except that such rate of 30 percent shall be reduced as may be provided by treaty with any country. 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 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.

(e) For withholding in the case of dividends distributed by a corporation organized under the China Trade Act, 1922 (15 U. S. C., c. 4), see §§ 39.143-3 and 39.262-4.

(f) For withholding in the case of rents under a Supplement U lease paid to a foreign corporation subject to the tax imposed by section 421 (a) see section 143 (h) and § 39.143-1 (a)

(g) Under the provisions of section 143 (b) the rate of tax withheld at the source shall not exceed 27½ percent in the case of interest on bonds, mortgages, or deeds of trust or other similar obligations of a corporation within the provisions of section 143 (a) (1) were it not for the fact that the maturity date of such obligations has been extended on or after January 1, 1934.

§ 39.144-2 *Aids to withholding agents in determining liability for withholding of tax.* (a) Since no withholding of tax on bond interest, dividends, or other income is required in the case of a resident foreign corporation (see § 39.143-3) 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 Internal Revenue Code. 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, Returns Section, Washington 25, D. C., except that, on and after July 19, 1953, such letter, or a copy thereof, shall be forwarded to the District Director of Internal Revenue, Baltimore 2, Maryland. 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 Code except in the case of interest on tax-free covenant bonds. The letter should be signed by a member of the firm.

(b) 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 a 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.

§ 39.145 *Statutory provisions; penalties.*

SEC. 145. *Penalties*—(a) *Failure to file returns, submit information, or pay estimated tax or tax.* Any person required under this chapter to pay any estimated tax or tax, or required by law or regulations made under authority thereof to make a return or declaration, keep any records, or supply any information, for the purposes of the computation, assessment, or collection of any estimated tax or tax imposed by this chapter, who willfully fails to pay such estimated tax or tax, make such return or declaration, 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) *Failure to collect and pay over tax, or attempt to defeat or evade tax.* Any person required under this chapter to collect, account for, and pay over any tax imposed by this chapter, 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 chapter 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) * * * [Repealed—see sec. 3809 (a) for corresponding provision of law.]

(d) *Person defined.* 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.

(e) * * * [Relates to taxable years beginning before October 1, 1950, and ending after September 30, 1950.]

(f) * * * [Relates to taxable years beginning before November 1, 1951, and ending after October 31, 1951.]

(g) *Cross reference.* For penalties for failure to file information returns with respect to foreign personal holding companies and foreign corporations, see section 340.

[Sec. 145 as amended by secs. 136 and 172 (f) (3), Rev. Act 1942; sec. (5) (c), Current Tax Payment Act 1943; sec. 6 (b) (6), Individual Income Tax Act 1944; sec. 4 (b), Pub. Law 271 (81st Cong.); sec. 1, Pub. Law 907 (81st Cong.); sec. 103 (a), Rev. Act 1951]

§ 39.145-1 *Penalties.* The penalties provided for in section 145 cannot be assessed but are enforceable only by suit or prosecution. For limitations on prosecutions, see section 3748. 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 statement required with reference thereto, make such persons subject to the penalties imposed by section 145 (a) Any person who willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury and which he does not believe to be true and correct as to every material matter, shall be guilty of a felony, and, if convicted, shall be fined not more than $2,000 or imprisoned not more than five years or both (see section 3809) 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.

§ 39.146 *Statutory provisions; closing by Commissioner of taxable year*

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.

§ 39.146–1 *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 exemptions for both normal tax and surtax provided by section 25 (b) if otherwise allowable, but the amount of such exemptions 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 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 section 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 section, 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 district director of internal revenue. 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 district director of internal revenue for the internal revenue 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 district director of internal revenue will issue a certificate of compliance to the applicant. A properly executed certificate of compliance issued by the district director of internal revenue 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 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 preceding taxable year where the period for making the income tax return for the 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 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 section, if properly executed and with adequate surety, are approved, and may be accepted in the name of the Commissioner, by the district director of internal revenue by signing the Form 1133 as follows:

Commissioner of Internal Revenue
By ------------------------
(District Director of Internal Revenue)

(d) A corporation will not be accepted as a surety on a 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.

§ 39.147 *Statutory provisions; information at source.*

SEC. 147. *Information at source*—(a) *Payments of $600 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 rent, 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 $600 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, 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.

[Sec. 147 as amended by sec. 7 (c), Rev. Act 1940; secs. 112 (c) and 116, Rev. Act 1941; sec. 131 (c) (3), Rev Act 1942; sec. 202 (c) (3), Rev. Act 1948; sec. 333, Rev. Act 1951]

§ 39.147-1 *Return of information as to payments of $600 or more.* (a) All persons making payment to another person of fixed or determinable income of $600 or more in any calendar year must render a return thereof for such year on or before February 28 of the following year except as specified in §§ 39.147-3 to 39.147-5, inclusive. 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. Returns of information on Forms 1096 and 1099 should be filed with the Commissioner of Internal Revenue, Processing Division, C. C. Station, Kansas City 2, Missouri. For place of filing Form 1041, see section 53. 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 section 39.143-2.

(b) Sums paid in respect of life insurance, endowment, or annuity contracts which are required to be included in gross income under §§ 39.22 (b) (1)-1, 39.22 (b) (2)-1, and 39.22 (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 section, except that payments in respect of policies surrendered before maturity and lapsed policies need not be reported.

(c) 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 section.

(d) 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.

§ 39.147-2 *Return of information as to payments to employees.* (a) The names of all employees to whom payments are made of $600 or more in any calendar year, whether such total sum is made up of wages, salaries, annuities, commissions, or compensation in any other form, must be reported. In the case of any such payments of $600 or more, if a portion thereof constitutes wages subject to withholding under section 1622 and such portion is reported on Form W-2, the remainder of such payments must be reported on Form 1099. For example, if such payments made to an employee by his employer in 1952 amount to $700 and $400 thereof represents wages subject to withholding under section 1622, and the remaining $300 represents compensation not subject to withholding, for instance, advances or reimbursements for traveling or other expenses, or insurance premiums which in accordance with § 39.165-6 are income to the employee for the year in which the insurance is purchased, the $400 must be reported on Form W-2 and the $300 must be reported on Form 1099. Heads of branch offices and subcontractors employing labor, who keep the only complete record of payments therefor, shall file returns of information in regard to such payments with the Commissioner of Internal Revenue, Processing Division, C. C. Station, Kansas City 2, Missouri. When both main office and branch office have adequate records, the return shall be filed by the main office.

(b) Amounts distributed or made available in any calendar year under an employees' trust governed by the provisions of section 165, or under an annuity plan to which § 39.22 (b) (2)-5 relates, to a beneficiary shall be reported to the extent such amounts are includible in the gross income of such beneficiary where the amounts so includible are $600 or more.

(c) In the case of payments made by the United States to persons in its service (civil or armed forces) of wages, salaries, or compensation in any other form, the returns of information shall be made by heads of the executive departments and other United States Government establishments.

(d) For cases where no returns of information are required, see § 39.147-3. See also § 39.22 (a)-3.

§ 39.147-3 *Cases where no return of information required.* (a) Payments of the following character, although amounting to $600 or more during a calendar year, need not be reported in returns of information on Form 1099:

(1) Payments by a broker to his customers;

(2) Payments of any type made to corporations;

(3) Bills paid for merchandise, telegrams, telephone, freight, storage, and similar charges;

(4) Payments of rent made to real estate agents (but the agent must report payments to the landlord if the amount paid during the calendar year was $600 or more)

(5) Payments representing earned income for services rendered without the United States made to a citizen of the United States, if it is reasonable to believe that such amounts will be excluded from gross income under the provisions of section 116 (a) and the regulations thereunder·

(6) Salaries and profits paid or distributed by a partnership to the individual partners;

(7) 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;

(8) Payments of income upon which income tax has been withheld at the source and reported on Forms 1012, 1013, and 1042, or Forms 941, W-2, and W-3;

(9) Amounts paid by the United States to persons in its service (civil or armed forces) as an allowance for traveling expenses, including an allowance for meals and lodgings, as, for example, a per diem allowance in lieu of sub-

sistence, and amounts paid as reimbursements for traveling expenses;

(10) Payments of interest on obligations of the United States or any agency or instrumentality thereof;

(11) Payments of interest on corporate bonds, except in the case of interest on bonds, mortgages, deeds of trust, or other similar obligations issued before January 1, 1934, and containing a tax-free covenant; and

(12) Payments made to employees for services performed in Puerto Rico.

(b) The provisions of this section shall not be applicable with respect to returns of information as to patronage dividends, rebates, or refunds required under section 148 (f) See § 39.148 (f)-1.

§ 39.147-4 *Return of information as to certain interest.* In the case of payments of interest, regardless of amount, upon bonds and similar obligations of corporations, and interest on obligations of the United States or any agency or instrumentality thereof, the ownership certificates, when duly filed, shall constitute and be treated as returns of information and in such cases no return of information on Form 1099 is required. See § 39.143-5. As to the requirements of filing ownership certificates for bond interest generally in the case of 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, and with respect only to interest on obligations containing a tax-free covenant and issued before January 1, 1934, in the case of a citizen or resident of the United States, a resident partnership and nonresident partnership all the members of which are citizens or residents of the United States, see § 39.143-4.

§ 39.147-5 *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 § 39.3797-8) the returns filed by withholding agents on Form 1042 shall constitute and be treated as returns of information. See sections 143 and 144.

§ 39.147-6 *Foreign items.* The term "foreign items," as used in the regulations in this part, 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 (including Puerto Rico as if a part of the United States) or any item of dividends upon the stock of such corporation.

§ 39.147-7 *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 $600 or more. Such forms accompanied by transmittal Form 1096 should be forwarded to the Commissioner of Internal Revenue, Processing Division, C. C. Station, Kansas City 2, Missouri, on or before February 28 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 §§ 39.147-1 and 39.147-3.

§ 39.147-8 *Information as to actual owner* (a) When the person receiving a payment falling within the provisions of the Internal Revenue Code 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, Processing Division, C. C. Station, Kansas City 2, Missouri, not later than February 28 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 § 39.148 (a)-1.

(b) The filing of Form 1087 is not required (1) 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 (2) if the actual owner or payee is a nonresident alien individual, foreign partnership, or foreign corporation and the tax has been withheld at the source before receipt of the dividends by the record owner. See § 39.143-1.

§ 39.148 (a) *Statutory provisions; information by corporations; dividend payments.*

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.

§ 39.148 (a)-1 *Return of information as to payments of dividends.* (a) 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:

(1) Except as provided in paragraph (b) of this section, 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) 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 $10 or more during the calendar year, shall render an information return on Forms 1096 and 1099. A separate Form 1099 must be prepared for each shareholder, upon which shall be shown the name and address of the shareholder to whom such payment was made, and the amount paid. These forms, accompanied by transmittal Form 1096 showing the number of Forms 1099 filed therewith, shall be filed with the Commissioner of Internal Revenue, Processing Division, C. C. Station, Kansas City 2, Missouri, on or before February 28 of the following year.

(2) The periodical distributions of earnings 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 the case of a distribution which is made from a depletion or depreciation reserve, or which for any other reason is deemed by the corporation to be nontaxable or partly nontaxable to its shareholders, the corporation shall fill in the information on both sides of Form 1096 and forward this form, together with Forms 1099, to the Commissioner of Internal Revenue, Processing Division, C. C. Station, Kansas City 2, Missouri, not later than February 1 of the following year. Upon receipt of this information the Commissioner will advise the corporation by letter as to any apparent errors made by the corporation in computing the nontaxable portion of the distribution in order that the corporation may, if time permits, furnish such advice to its shareholders before the shareholders file their income tax returns for the year in which the distribution was made. In the case of a corporation described in section 101 (10) (11) (12) or (13), making a payment of a dividend or a distribution to any shareholder, the information return on Forms 1096 and 1099 shall be rendered only in the case of payments amounting to $100 or more during the calendar year. In

the case of a savings and loan association, a cooperative bank, a homestead association, a credit union, or a building and loan association an information return is required to be filed with respect to dividends or distributions to a shareholder only if an information return would have been required under the provisions of § 39.147-1 had the dividends or distributions been payments of interest, except that, for years prior to 1953, such an organization is required to file an information return where the payments to a shareholder amount to $100 or more during the calendar year.

(c) In any case in which it is impossible to file the return within the time prescribed in this section, the corporation may, upon a showing of such fact, obtain a reasonable extension of time for filing the return. Authority for granting extensions of time for filing the return of information is hereby delegated to the various district directors of internal revenue. Applications for such extensions shall be addressed to the district director of internal revenue for the internal revenue district in which the corporation files its income tax returns, must contain a full recital of the causes for the delay and must be submitted on or before the date prescribed for filing the return of information. No extension may be granted for more than six months.

§ 39.148 (b)-(d) *Statutory provisions; information by corporations; profits declared as dividends; accumulated earnings and profits; contemplated dissolution or liquidation.*

SEC. 148. *Information by corporations.* * * *

(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 Commssioner 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 indivduals 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.

§ 39.148 (d)-1 *Return of information respecting contemplated dissolution or liquidation*—(a) *Making and filing of returns.* Within 30 days after the adoption 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 district director of internal revenue (Commissioner of Internal Revenue, Washington 25, D. C., prior to the date of publication of this section in the FEDERAL REGISTER) a correct return on Form 966, containing the information required by paragraph (b) of this section 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. 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 section 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 within one calendar month.* In the event that the corporation is a domestic corporation and the plan of liquidation 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 some one calendar month pursuant to section 112 (b) (7) and any shareholder claims the benefit of such section, such return shall, in addition to the information required by subparagraph (1) of this paragraph, contain the following:

(i) A statement showing the number of shares of each class of stock outstanding at the time 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 at the time 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 August 15, 1950, 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 August 15, 1950, 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 section 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 section and by Form 966.

§ 39.148 (e) *Statutory provisions; information by corporations; distributions in liquidation.*

SEC. 148. *Information by corporations.* * * *

(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.

§ 39.148 (e)-1 *Return of information respecting distributions in liquidation.* (a) Unless the distribution is one in respect of which information is required to be filed pursuant to § 39.112 (b) (6)-5 (b) § 39.112 (g)-6 (a), or § 39.371-11, every corporation making any distribution of $600 or more during a calendar year to any shareholder 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 the regulations in this part. A separate Form 1099L must be prepared 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 forms, accom-

panied by transmittal Form 1096 showing the number of Forms 1099L filed therewith, shall be filed with the Commissioner of Internal Revenue, Processing Division, C. C. Station, Kansas City 2, Missouri, on or before February 28 of the year following the calendar year in which such distribution was made.

(b) If the distribution is in complete liquidation of a domestic corporation pursuant to a plan of liquidation 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 within some one calendar month pursuant to section 112 (b) (7) and any shareholder claims the benefit of such section, 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 the close of such calendar month, without diminution by reason of distributions made during such calendar month, but including in such computation all items of income and expense accrued up to the date on which the transfer of all the property under the liquidation is completed, (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.

§ 39.148 (f) *Statutory provisions; information by corporations; patronage dividends.*

SEC. 148. *Information by corporations.* * * *

(f) *Patronage dividends.* Any corporation allocating amounts as patronage dividends, rebates, or refunds (whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the amount of such dividend, refund, or rebate) shall render a correct return stating (1) the name and address of each patron to whom it has made such allocations amounting to $100 or more during the calendar year, and (2) the amount of such allocations to each patron. If required by the Secretary, any such corporation shall render a correct return of all patronage dividends, rebates, or refunds made during the calendar year to its patrons. This subsection shall not apply in the case of any corporation (including any cooperative or nonprofit corporation engaged in rural electrification) exempt from taxation under section 101 (10) or (11) or in the case of any corporation subject to a tax imposed by supplement G.

[Sec. 148 (f) as amended by sec. 407, Rev. Act 1939; sec. 5, Pub. Law 271 (81st Cong.); sec. 314 (c), Rev. Act 1951]

§ 39.148 (f)-1 *Returns of information as to patronage dividends, rebates, or refunds*—(a) *In general.* Any corporation allocating to any patron amounts aggregating $100 or more during the calendar year as patronage dividends, rebates, or refunds (whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, letters of advice, or in some other manner that discloses to each patron the amount of such dividend, rebate, or refund) shall for each calendar year render a return of information with respect to such allocation on Forms 1096 and 1099. The allocation shall be reported for the calendar year during which the allocation is made, regardless of whether the allocation is deemed for the purpose of section 101 (12) (B) to be made at the close of a preceding taxable year of the corporation.

(b) *Contents of return; manner of making and filing.* A separate Form 1099 shall be prepared for each patron showing the name and address of the patron to whom such allocation is made, and the amount of the allocation. These forms, accompanied by transmittal Form 1096, showing the number of Forms 1099 filed therewith, shall be filed with the Commissioner of Internal Revenue, Processing Division, C. C. Station, Kansas City 2, Missouri, on or before February 28 of the following year.

(c) *Extension of time for filing.* In any case in which it is impossible to file the return within the time prescribed in this section, the corporation may, upon a showing of such fact, obtain a reasonable extension of time for filing the return. Authority for granting extensions of time for filing the return of information is hereby delegated to the various district directors of internal revenue. Applications for such extensions shall be addressed to the district director of internal revenue for the internal revenue district in which the corporation is required to file its income tax return, must contain a full recital of the causes for the delay, and must be submitted on or before the date prescribed for filing the return of information. No extension may be granted for more than six months.

(d) *Definitions.* The terms "cooperative association" "patron" "patronage dividends, rebates, and refunds", and "allocation" are defined, for the purpose of this section, in § 39.101 (12)-2 (b).

§ 39.149—150 *Statutory provisions; returns of brokers; collection of foreign items.*

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.

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 chapter 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.

§ 39.150-1 *License to collect foreign items.* Banks or agents collecting foreign items, as defined in § 39.147-6, and required by § 39.147-7 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 district directors of internal revenue. The license is issued without cost on Form 1010. Any person holding a license under the Revenue Act of 1938 or any prior act will not be required to renew such license.

§ 39.151-153 *Statutory provisions; foreign personal holding companies; Pan-American trade corporations; information required from certain tax-exempt organizations and certain trusts.*

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.

For information returns by attorneys, accountants, and so forth, as to formation, and so forth, of foreign croporations, see section 3604.

SEC. 152. *Pan-American trade corporations.* [Made inapplicable to taxable years beginning after December 31, 1941, by sec. 153 (b), Rev. Act 1942]

SEC. 153. *Information required from certain tax-exempt organizations and certain trusts*—(a) *Certain tax-exempt organizations.* Every organization described in section 101 (6) which is subject to the requirements of section 54 (f) shall furnish annually information, at such time and in such manner as the Secretary may by regulations prescribe, setting forth—

(1) Its gross income for the year,

(2) Its expenses attributable to such income and incurred within the year,

(3) Its disbursements out of income within the year for the purposes for which it is exempt,

(4) Its accumulation of income within the year,

(5) Its aggregate accumulations of income at the beginning of the year,

(6) Its disbursements out of principal in the current and prior years for the purposes for which it is exempt, and

(7) A balance sheet showing its assets, liabilities and net worth as of the beginning of such year.

(b) *Trusts claiming charitable, etc., deductions under section 162 (a).* Every trust claiming a charitable, etc., deduction under section 162 (a) for the taxable year shall furnish information with respect to such taxable year, at such time and in such manner as the Secretary may by regulations prescribe, setting forth—

(1) The amount of the charitable, etc., deduction taken under section 162 (a) within such year (showing separately the amount of such deduction which was paid out and the amount which was permanently set aside for charitable, etc., purposes during such year),

(2) The amount paid out within such year which represents amounts for which charitable, etc., deductions under section 162 (a) have been taken in prior years,

(3) The amount for which charitable, etc., deductions have been taken in prior years but which has not been paid out at the beginning of such year,

(4) The amount paid out of principal in the current and prior years for charitable, etc., purposes,

(5) The total income of the trust within such year and the expenses attributable thereto, and

(6) A balance sheet showing the assets, liabilities, and net worth of the trust as of the beginning of such year.

This subsection shall not apply in the case of a taxable year if all the net income for such year, determined under the applicable principles of the law of trusts, is required to be distributed currently to the beneficiaries.

(c) *Information available to the public.* The information required to be furnished by subsections (a) and (b), together with the names and addresses of such organizations and trusts, shall be made available to the public at such times and in such places as the Secretary may prescribe.

(d) *Penalties.* In the case of a willful failure to furnish the information required under this section, the penalties provided in section 145 (a) shall be applicable.

[Sec. 153 as added by sec. 341 (a), Rev. Act 1950; amended by Pub. Law 35 (82d Cong.)]

§ 39.153-1 *Information required from certain tax-exempt organizations.* (a) Every organization described in section 101 (6) except organizations specifically exempt from filing annual returns under section 54 (f) (see § 39.101-1 (h)) shall file a return of information on Form 990-A. The return shall be on the basis of the established annual accounting period of the organization. Where the organization has no established annual accounting period, the return shall be made on the basis of the calendar year. The return shall be filed on or before the fifteenth day of the fifth full calendar month following the close of the period for which the return is required to be filed, and it shall be filed with the district director of internal revenue for the internal revenue district in which is located the principal place of business or principal office of the organization.

(b) Pages 3 and 4 of the return shall set forth the name and address of the organization, and the following information concerning the organization in such detail as may be prescribed by the Commissioner in the instructions on the form or issued by him therewith:

(1) Its gross income for the year in sufficient detail to show the different categories of income,

(2) Its expenses attributable to such income and incurred within the year, in sufficient detail to show the different categories of expense,

(3) Its disbursements made within the year out of current or accumulated income for the purpose for which it is exempt, separately listing the total amount of disbursements for each classification of the exempt purposes of the organization,

(4) Its accumulation of income within the year,

(5) Its aggregate accumulation of income at the beginning of the year,

(6) (i) Its disbursements made out of principal during the current year for the purpose for which it is exempt, separately listing the total amount of disbursements for each classification of the exempt purposes of the organization,

(ii) Its disbursements made out of principal during prior years for the purpose for which it is exempt,

(7) The total of its administrative and operating expenses disbursed out of both principal and income,

(8) A balance sheet showing its assets, liabilities, and net worth as of the beginning of the year.

§ 39.153-2 *Information required of certain trusts claiming charitable or other deductions under section 162 (a)*—(a) *In general.* Every trust (other than a trust described in paragraph (b) of this section) claiming a charitable or other deduction under section 162 (a) shall file, with respect to the taxable year for which such deduction is claimed, a return of information on Form 1041-A. The return shall be filed on or before the fifteenth day of the fourth month following the close of the taxable year of the trust with the district director of internal revenue for the internal revenue district in which the fiduciary resides or has his principal place of business. The return shall set forth the name and address of the trust and the following information concerning the trust in such detail as may be prescribed by the Commissioner in the instructions on the form or issued by him therewith.

(1) The amount of the charitable or other deduction taken under section 162 (a) for the taxable year, showing separately for each class of activity for which disbursements were made (or amounts were permanently set aside) the amounts which, during such year, were paid out (or which were permanently set aside) for charitable or other purposes under section 162 (a)

(2) The amount paid out during the taxable year which represents amounts permanently set aside in prior years for which charitable or other deductions have been taken under section 162 (a) and separately listing for each class of activity for which disbursements were made, the total amount paid out,

(3) The amount for which charitable or other deductions have been taken in prior years under section 162 (a) and which had not been paid out at the beginning of the taxable year,

(4) (i) The amount paid out of principal in the taxable year for charitable, etc., purposes, and separately listing for each such class of activity for which disbursements were made, the total amount paid out,

(ii) The total amount paid out of principal in prior years for charitable, etc., purposes,

(5) The gross income of the trust for the taxable year and the expenses attributable thereto, in sufficient detail to show the different categories of income and of expense, and

(6) A balance sheet showing the assets, liabilities, and net worth of the trust as of the beginning of the taxable year.

(b) *Exception.* The provisions of paragraph (a) of this section with respect to the filing of information returns shall not be applicable to the taxable year of a trust if the trustee is bound by the instrument creating the trust to distribute each year to the beneficiaries all the net income of the trust (such net income being determined under the applicable principles of the law of trusts)

§ 39.153-3 *Publicity of returns.* The information furnished on pages 3 and 4 of Form 990-A and the information furnished on Form 1041-A shall be a matter of public record, and shall be open to public inspection, during regular hours of business, in the office of the district director of internal revenue for the internal revenue district in which the forms are filed. The Commissioner may use such information for the purpose of making and publishing statistical or other studies.

§ 39.153-4 *Penalties.* In the case of a willful failure to furnish the information required under section 153 and §§ 39.153-1 and 39.153-2, the penalties provided in section 145 (a) shall be applicable.

§ 39.154 *Statutory provisions; income taxes of members of armed forces upon death.*

SEC. 154. *Income taxes of members of Armed forces upon death.* In the case of any individual who dies after June 24, 1950, and prior to January 1, 1954, while in active service as a member of the Armed Forces of the United States, if such death occurred while serving in a combat zone (as determined under section 22 (b) (13)) or as a result of wounds, disease, or injury incurred while so serving—

(a) The tax imposed by this chapter shall not apply with respect to the taxable year in which falls the date of his death, or with respect to any prior taxable year ending on or after the first day he so served in a combat zone after June 24, 1950; and

(b) The tax under this chapter and under the corresponding title of each prior revenue law for taxable years preceding those specified in clause (a) which is unpaid at the date of his death (including interest, additions to the tax, and additional amounts) shall not be assessed, and if assessed the assessment shall be abated, and if collected shall be credited or refunded as an overpayment.

[Sec. 154 as added by sec. 334, Rev. Act 1951]

§ 39.154-1 *Abatement of income taxes of certain members of the armed forces of the United States upon death.* (a) If an individual dies after June 24, 1950, and before January 1, 1954, while in active service as a member of the armed forces of the United States, and such death occurs while serving in a combat zone, as determined under section 22 (b) (13) or at any place as a result of wounds, disease, or injury incurred while so serving, then—

(1) The tax liability of such individual under chapter 1 for the taxable year ending on the date of his death, or for any prior taxable year ending on or after the first day he so served in a combat zone after June 24, 1950, is cancelled and if the tax (including interest, additions to the tax, and additional amounts) is assessed, the assessment shall be abated, and if the amount of such tax is collected (regardless of the date of collection) the amount so collected shall be credited or refunded as an overpayment; and

(2) That amount of tax of such individual for taxable years preceding those

specified in subparagraph (1) of this paragraph under chapter 1, or corresponding provisions of prior revenue laws, which remains unpaid as of the date of death shall not be assessed, and if any such unpaid tax (including interest, additions to the tax, and additional amounts) has been assessed, such assessment shall be abated, and if the amount of any such unpaid tax is collected subsequent to the date of death, the amount so collected shall be credited or refunded as an overpayment.

(b) If such an individual and his spouse have for any such year filed a joint return, the tax abated, credited, or refunded pursuant to the provisions of section 154 for such year shall be an amount equal to that portion of the joint tax liability which is the same percentage of such joint tax liability as a tax computed upon the separate income of such individual is of the sum of the taxes computed upon the separate income of such individual and his spouse, but with respect to taxable years ending before June 24, 1950, and with respect to taxable years ending before the first day such individual served in a combat zone, as determined under section 22 (b) (13), the amount so abated, credited, or refunded shall not exceed the amount unpaid at the date of death. For such purpose, the separate tax of each spouse shall be the tax computed under chapter 1 before the application of sections 32, 35, and 322 (a) but after the application of section 31, as if such spouse were required to make a separate return.

(c) If such an individual and his spouse filed a joint declaration of estimated tax for the taxable year ending with the date of his death, the estimated tax paid pursuant to such declaration may be treated as the estimated tax of either such individual or his spouse, or may be divided between them, in such manner as his legal representative and such spouse may agree. Should they agree to treat such estimated tax, or any portion thereof, as the estimated tax of such individual, the estimated tax so paid shall be credited or refunded as an overpayment for the taxable year ending with the date of his death.

(d) For the purpose of determining the tax which is unpaid at the date of death, amounts deducted and withheld under subchapter D of chapter 9 constitute payment of a tax imposed under chapter 1.

(e) This section shall have no application whatsoever with respect to the liability of an individual as a transferee of property of a taxpayer where such liability relates to the tax imposed upon the taxpayer by chapter 1.

(f) As to what constitutes active service as a member of the armed forces, service in a combat zone, and wounds, disease, or injury incurred while serving in a combat zone, see § 39.22 (b) (13)-1. As to who are members of the armed forces, see § 39.3797-11.

SUPPLEMENT E—ESTATES AND TRUSTS

§ 39.161 *Statutory provisions; estates and trusts; imposition of tax.*

SEC. 161. *Imposition of tax*—(a) *Application of tax.* The taxes imposed by this chapter (other than the tax imposed by subchapter E, relating to tax on self-employment income) 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).

(c) *Cross reference.* For return made by beneficiary, see section 142.

[Sec. 161 as amended by sec. 203 (d) (7), Social Security Act Amendments 1950]

§ 39.161-1 *Imposition of the tax*—(a) *Scope.* (1) Supplement E (sections 161 to 172, inclusive) prescribes that the taxes imposed upon individuals by chapter 1 (other than the tax on self-employment income imposed by section 480) 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.

(2) The several classes of income enumerated and described in the paragraphs of section 161 (a) do not exclude others which also may come within the general purpose of section 161 (a)

(3) A guardian, whether of an infant or other person, is a fiduciary (see section 3797 (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 §§ 39.51-3 and 39.142-2. 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.

(4) 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 Internal Revenue Code, 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 the income is attributable to the grantor are likewise excluded from the scope of sections 161, 162, and 163. For example, a grantor is taxable under section 22 (a) on the income of a trust if he is still in practical effect the owner of the income. See § 39.22 (a)-21. A grantor is also taxable under section 22 (a) on the income of a trust providing for the payment and application of such income in satisfaction of his legal obligations. So-called alimony trusts to which section 22 (k) or section 171 applies may be of a type to which the provisions of sections 161, 162, and 163 also apply, or of a type which is excluded from the provisions of sections 161, 162, and 163. Except to the extent that section 22 (k) or section 171 governs the taxability of amounts paid, credited, or to be distributed attributable to trust property, the treatment of such trusts under sections 161, 162, and 163 or under sections 22 (a) 166, and 167 is not affected by section 22 (k) or section 171. See section 165 as to the exemptions 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 22 (a) 165, 166, and 167, and §§ 39.22 (a)-21, 39.22 (a)-22, 39.166-1, and 39.167-1. 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.

§ 39.162 *Statutory provisions; estates and trusts; net income.*

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) Subject to the provisions of subsection (g), 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 purposes 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. Where any amount of the income so paid or set aside is attributable to gain from the sale or exchange of capital assets held for more than six months, proper adjustment of the deduction otherwise allowable under this subsection shall be made for any deduction allowable to the trust under section 23 (ee);

(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 legatees, heirs, or beneficiaries, but the amount so allowed as a deduction shall be included in computing the net income of the legatees, heirs, or beneficiaries whether distributed to them or not. As used in this subsection, "income which is to be distributed currently" includes income for the taxable year of the estate or trust which, within the taxable year, becomes payable to the legatee, heir, or beneficiary. 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;

(d) *Rules for application of subsections (b) and (c).* For the purposes of subsections (b) and (c)—

(1) *Amounts distributable out of income or corpus.* In cases where the amount paid, credited, or to be distributed can be paid, credited, or distributed out of other than income, the amount paid, credited, or to be distributed (except under a gift, bequest, devise, or inheritance not to be paid, credited, or distributed at intervals) during the taxable year of the estate or trust shall be considered as income of the estate or trust which is paid, credited, or to be distributed if the aggregate of such amounts so paid, credited, or to be distributed does not exceed the distributable income of the estate or trust for its taxable year. If the aggregate of such amounts so paid, credited, or to be distributed during the taxable year of the estate or trust in such cases exceeds the distributable income of the estate or trust for its taxable year, the amount so paid, credited, or to be distributed to any legatee, heir, or beneficiary shall be considered income of the estate or trust for its taxable year which is paid, credited, or to be distributed in an amount which bears the same ratio to the amount of such distributable income as the amount so paid, credited, or to be distributed to the legatee, heir, or beneficiary bears to the aggregate of such amounts so paid, credited, or to be distributed to legatees, heirs, and beneficiaries for the taxable year of the estate or trust. For the purposes of this paragraph "distributable income" means either (A) the net income of the estate or trust computed with the deductions allowed under subsections (b) and (c) in cases to which this paragraph does not apply, or (B) the income of the estate or trust minus the deductions provided in subsections (b) and (c) in cases to which this paragraph does not apply, whichever is the greater. In computing such distributable income the deductions under subsections (b) and (c) shall be determined without the application of paragraph (2).

(2) *Amounts distributable out of income of prior period.* In cases, other than cases described in paragraph (1), if on a date more than 65 days after the beginning of the taxable year of the estate or trust, income of the estate or trust for any period becomes payable, the amount of such income shall be considered income of the estate or trust for its taxable year which is paid, credited, or to be distributed to the extent of the income of the estate or trust for such period, or if such period is a period of more than 12 months, the last 12 months thereof.

(3) *Distributions in first 65 days of taxable year*—(A) *General rule.* If within the first 65 days of any taxable year of the estate or trust, income of the estate or trust, for a period beginning before the beginning of the taxable year, becomes payable, such income, to the extent of the income of the estate or trust for the part of such period not falling within the taxable year or, if such part is longer than 12 months, the last 12 months thereof, shall be considered, paid, credited, or to be distributed on the last day of the preceding taxable year. This subparagraph shall not apply with respect to any amount with respect to which subparagraph (B) applies.

(B) *Payable out of income or corpus.* If within the first 65 days of any taxable year of the estate or trust, an amount which can be paid at intervals out of other than income becomes payable, there shall be considered as paid, credited, or to be distributed on the last day of the preceding taxable year the part of such amount which bears the same ratio to such amount as the part of the interval not falling within the taxable year bears to the period of the interval. If the part of the interval not falling within the taxable year is a period of more than 12 months, the interval shall be considered to begin on the date 12 months before the end of the taxable year.

(4) *Excess deductions.* If for any taxable year of an estate or trust the deductions allowed under subsection (b) or (c) solely by reason of paragraph (2) or (3) (A) in respect of any income which becomes payable to a legatee, heir, or beneficiary exceed the net income of the estate or trust for such year, computed without such deductions, the amount of such excess shall not be included in computing the net income of such legatee, heir, or beneficiary under subsection (b) or (c). In cases where the income deductible solely by reason of paragraph (2) or (3) (A) becomes payable to two or more legatees, heirs, or beneficiaries, the benefit of such exclusion shall be divided among such legatees, heirs, and beneficiaries, in the proportions in which they share in such income. In any case where the estate or trust is entitled to a deduction by reason of paragraph (1), in the determination of the net income of the estate or trust for the purposes of this paragraph the amount of such deduction shall be determined with the application of paragraph (3) (A).

(e) Amounts allowable under section 812 (b) as a deduction in computing the net estate of a decedent shall not be allowed as a deduction under section 23, except subsection (w), in computing the net income of the estate unless there is filed, within the time and in the manner and form prescribed by the Commissioner, a statement that the items have not been claimed or allowed as deductions under section 812 (b) and a waiver of the right to have such items allowed at any time as deductions under section 812 (b).

(f) The standard deduction provided in section 23 (aa) shall not be allowed.

(g) *Rules for application of subsection (a) in the case of trusts*—(1) *Trade or business income.* In computing the deduction allowable under subsection (a) to a trust for any taxable year beginning after December 31, 1950, no amount otherwise allowable under subsection (a) as a deduction shall be allowed as a deduction with respect to income of the taxable year which is allocable to its supplement U business income for such year. As used in this paragraph the term "supplement U business income" means an amount equal to the amount which, if such trust were exempt under section 101 (6) from taxation, would be computed as its unrelated business net income under section 422 (relating to income derived from certain business activities and from certain leases).

(2) *Operations of trusts*—(A) *Limitation on charitable, etc., deduction.* The amount otherwise allowable under subsection (a) as a deduction shall not exceed 15 per centum of the net income of the trust (computed without the benefit of subsection (a) if the trust has engaged in a prohibited transaction, as defined in subparagraph (B) of this paragraph.

(B) *Prohibited transactions.* For the purposes of this paragraph the term "prohibited transaction" means any transaction after July 1, 1950, in which any trust while holding income or corpus which has been permanently set aside or is to be used exclusively for charitable or other purposes described in subsection (a)—

(i) Lends any part of such income or corpus, without receipt of adequate security and a reasonable rate of interest to;

(ii) Pays any compensation from such income or corpus, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

(iii) Makes any part of its services available on a preferential basis to;

(iv) Uses such income or corpus to make any substantial purchase of securities or any other property, for more than an adequate consideration in money or money's worth, from;

(v) Sells any substantial part of the securities or other property comprising such income or corpus, for less than an adequate consideration in money or money's worth, to; or

(vi) Engages in any other transaction which results in a substantial diversion of such income or corpus to;

the creator of such trust; any person who has made a substantial contribution to such trust; a member of the family (as defined in section 24 (b) (2) (D)) of an individual who is the creator of the trust or who has made a substantial contribution to the trust; or a corporation controlled by any such creator or person through the ownership, directly or indirectly, of 50 per centum or more of the total combined voting power of all classes of stock entitled to vote or 50 per centum or more of the total value of shares of all classes of stock of the corporation.

(C) *Taxable years affected.* The amount otherwise allowable under subsection (a) as a deduction shall be limited as provided in subparagraph (A) only for taxable years subsequent to the taxable year during which the trust is notified by the Secretary that it has engaged in such transaction, unless such trust entered into such prohibited transaction with the purpose of diverting such corpus or income from the purposes described in subsection (a), and such transaction involved a substantial part of such corpus or income.

(D) *Future charitable, etc., deductions of trusts denied deduction under subparagraph (C).* If the deduction of any trust under subsection (a) has been limited as provided in this paragraph, such trust, with respect to any taxable year following the taxable year in which notice is received of limitation of deduction under subsection (a), may, under regulations prescribed by the Secretary, file claim for the allowance of the unlimited deduction under subsection (a), and if the Secretary, pursuant to such regulations, is satisfied that such trust will not knowingly again engage in a prohibited transaction, the limitation provided in subparagraph (A) shall not be applicable with respect to taxable years subsequent to the year in which such claim is filed.

(E) *Disallowance of certain charitable, etc., deductions.* No gift or bequest for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art, and the prevention of cruelty to children or animals), otherwise allowable as a deduction under section 23 (o) (2), 23 (q) (2), 162 (a), 505 (a) (2), 812 (d), 861 (a) (3), 1004 (a) (2) (B), or 1004 (b) (2) or (3), shall be allowed as a deduction if made in trust and, in the taxable year of the trust in which the gift or bequest is made, the deduction allowed the trust under subsection (a) is limited by subparagraph (A). With respect to any taxable year of a trust in which such deduction has been so limited by reason of entering into a prohibited transaction with the purpose of diverting such corpus or income from the purposes described in subsection (a), and such transaction involved a substantial part of such

income or corpus, and which taxable year is the same, or prior to the, taxable year of the trust in which such prohibited transaction occurred, such deduction shall be disallowed the donor only if such donor or (if such donor is an individual) any member of his family (as defined in section 24 (b) (2) (D)) was a party to such prohibited transaction.

(F) *Definition.* For the purposes of this paragraph the term "gift or bequest" means any gift, contribution, bequest, devise, legacy, or transfer.

(3) *Cross reference.* For disallowance of certain charitable, etc., deductions otherwise allowable under subsection (a), see section 3813.

(4) *Accumulated income.* If the amounts permanently set aside, or to be used exclusively for the charitable and other purposes described in subsection (a) during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(A) Are unreasonable in amount or duration in order to carry out such purposes of the trust; or

(B) Are used to a substantial degree for purposes other than those described in subsection (a); or

(C) Are invested in such a manner as to jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries,

the amount otherwise allowable under subsection (a) as a deduction shall be limited to the amount actually paid out during the taxable year and shall not exceed 15 per centum of the net income of the trust (computed without the benefit of subsection (a)).

[Sec. 162 as amended by secs. 111 (b), (c), 161 (a), Rev. Act 1942; sec. 133, Rev. Act 1943; sec. 9 (b) (1), Individual Income Tax Act 1944; sec. 321 (a), (b), Rev. Act 1950; sec. 322 (c) (5), Rev. Act 1951]

SEC. 11. *Denial of tax deductions and exemptions [Internal Security Act of 1950].* (a) Notwithstanding any other provision of law, no deduction for Federal income-tax purposes shall be allowed in the case of a contribution to or for the use of any organization if at the time of the making of such contribution (1) such organization is registered under section 7, or (2) there is in effect a final order of the Board [the Subversive Activities Control Board] requiring such organization to register under section 7.

* * * * *

§ 39.162–1 *Income of estates and trusts.* (a) In ascertaining the tax liability of the estate of a deceased person or of a trust, there are 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. Amounts allowable under section 812 (b) as a deduction in computing the net estate of a decedent are not allowed as a deduction under section 23, except subsection (w) in computing the net income of the estate unless there is filed in duplicate a statement to the effect that the items have not been claimed or allowed as deductions from the gross estate of the decedent under section 812 (b) and a waiver of any and all right to have such item allowed at any time as a deduction under section 812 (b) Such statement and waiver should be filed with the return for the year for which the item is claimed as a deduction, or with the Commissioner, or with the district director of internal revenue for the internal revenue district in which such return was filed, for association with the return. For items not deductible, see section 24. For limitations on the deduction otherwise allowable under section 162 (a) see section 3813. See also paragraph (b) (1) of this section, and §§ 39.162–3 and 39.162–4. Against the net income of the estate or trust there are allowable certain credits, for which see sections 25 and 163.

(b) 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 paragraph (a) of this section) 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 section 162 (a) This deduction is in lieu of that authorized by section 23 (o) in the case of individual taxpayers. In the case of a trust, the deduction otherwise allowable under section 162 (a) is subject to the limitations of section 162 (g). See §§ 39.162–3 and 39.162–4. Where any amount of the income so paid or set aside for the charitable uses or purposes referred to or described in section 162 (a) is attributable to gain from the sale or exchange of capital assets held for more than six months, the amount of the deduction allowable under section 162 (a) must be determined with regard to the inclusion of 100 percent of such gains in gross income and with appropriate adjustment for the deduction provided in sections 23 (ee) and 117 (b) of 50 percent of the excess, if any, of the net long-term capital gain over the net short-term capital loss. See § 39.117 (b)–1 (a) The application of this rule is illustrated by the following example:

Example. Under the terms of a trust created by the will of a decedent, the trust net income (including capital gains) is to be distributed, one-half to certain individual beneficiaries and one-half to M University, an organization exempt from taxation under section 101 (6). During 1952 the trust has ordinary net income of $100,000, plus $100,000 of gains from the sale of capital assets held for more than six months. In computing the gross income of the trust for tax purposes 100 per cent of such gains are includible. M University receives a total of $100,000 from the trust in respect of the year 1952. However, the amount allowable to the trust as a deduction under section 162 (a) is subject to appropriate adjustment for the deduction allowable under section 23 (ee). In view of the distributions made to individual beneficiaries, the deduction allowable to the trust under section 23 (ee) is limited by the provisions of section 117 (b) to $25,000. Since the whole of this deduction is attributable to the distribution to M University, the deduction allowable in 1952 to the trust under section 162 (a) will be $75,000.

See § 39.153–2 relating to the annual information return that must be filed by certain trusts claiming charitable, etc., deductions under section 162 (a) for the taxable year.

(2) Any income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to a legatee, heir, or beneficiary, whether or not such income is actually distributed. For this purpose, it is provided in section 162 (b) that "income which is to be distributed currently" includes income of the estate or trust which, within the taxable year, becomes payable to the legatee, heir, or beneficiary.

(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.

(4) Any income of the class described in subparagraph (2) or (3) of this paragraph 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.

(c) There is included in the income of the estate or the trust, unless it is included in the income of the grantor of the trust, or in the income of some other person granted the power exercisable solely by himself to vest the property in himself. See §§ 39.166–1, 39.167–1, 39.22 (a)–21, and 39.22 (a)–22.

(1) All income thereof accumulated for the benefit of unborn or unascertained persons or persons with contingent interests,

(2) All income either accumulated or held for future distribution pursuant to the terms of the will or trust,

(3) All other income of the estate or trust for its taxable year which is not to be distributed currently to legatees or other beneficiaries (see paragraph (b) (2) of this section),

(4) All income of the estate for its taxable year not properly paid or credited during such year to a legatee or heir, and

(5) 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 (b) (3) of this section).

In all such cases the tax with respect to such income included in the income of the estate or trust for its taxable year is payable by the fiduciary, except where the income is deductible by the estate or trust for such taxable year (and is includible in the income of the legatee or beneficiary).

(d) Income described in paragraph (c) (1) (2) (4) and (5) of this section may, in some cases, be deductible by the estate or trust under paragraph (b) (2) of this section. It is expressly provided in section 162 (b) that such income of the estate or trust for its taxable year which, within its taxable year, becomes payable to the legatee, heir, or beneficiary is deductible by the estate or trust. Thus, if income of a trust is to be accumulated until A, the beneficiary, reaches his twenty-first birthday, which is December 31, 1952, the income of the

trust (assuming the income tax returns of the trust are made on the calendar year basis) for the calendar year 1952 is to be deducted by the trust under section 162 (b) in computing its net income for 1952 and is to be included in the income of A for his taxable year in which December 31, 1952, falls. In the case of a similar trust, where the twenty-first birthday of B, the beneficiary was on July 1, 1952, and the income of the trust was to be accumulated until that date and then to be distributed to B at such time as the trustee in his discretion decides, if the trustee on December 31, 1952, decides to distribute the accumulated income to B, the income becomes payable to B on December 31, 1952, whether distributed to him or not. In such a case, the extent to which such amount is considered to be payable out of income of the trust for its taxable year is determined under section 162 (d) (2) and § 39.162-2 (b)

(e) Any amount described in paragraph (b) (2) and (3) of this section 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. As to the amount of income of the estate or trust which is considered paid, credited, or to be distributed, and the time thereof, for the purposes of the deduction under paragraph (b) (2) and (3) of this section and the inclusion in income of the legatee, heir, or beneficiary, see section 162 (d) and § 39.162-2.

(f) 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, except in cases to which section 22 (k) or section 171 applies. See §§ 39.167-1, 39.171-1, and 39.171-2.

(g) The income of an estate of a deceased person, as dealt with in the Internal Revenue Code, 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 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, except to the extent that under the principles of § 39.162-2 such allowance is taxable to the widow. 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.

(h) 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 for a taxable year, the net income on which the tax is so paid is not, generally, in the hands of the distributee thereof (the legatee, heir, or beneficiary) taxable as income to him, but if such income becomes payable in a subsequent taxable year of the estate or trust it may be required to be included in the income of the distributee under section 162 (d) (2) or (3) See § 39.162-2 (b) (c) and (d)

(i) 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. 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.

§ 39.162-2 *Allocation of estate and trust income to legatees and beneficiaries*—(a) *Allocation among annuitants.* (1) Section 162 (d) (1) applies to all cases in which the executor or trustee can or must (for example, by the terms of the trust instrument or will) pay the whole or any part of a gift, bequest, devise, or inheritance out of other than income, except that no income is to be allocated under it to a legatee, heir, or beneficiary of a lump-sum gift, bequest, devise, or inheritance. It applies in all cases of annuities where any deficiency in the amount to be paid can be made up by a payment out of corpus of the trust. It also applies in cases where amounts are to be paid or credited at intervals and the executor or trustee has discretion whether to pay or credit such amounts out of income or corpus, regardless of the source (income or corpus) to which the executor or trustee attributes such amount. If an annuity is paid, credited, or to be distributed tax-free, that is, under a provision whereby the executor or trustee will pay the income tax of the annuitant resulting from the receipt of the annuity, the payment of or for the tax by the executor or trustee will be income to the annuitant under the rules of section 162 (d) to the extent such payment is treated thereunder as out of income.

(2) The method of allocating income of the estate or trust for its taxable year in cases to which section 162 (d) (1) applies is as follows: The aggregate of all amounts which can be paid, credited, or distributed out of other than income (except under a gift, bequest, devise, or inheritance not to be paid, credited, or to be distributed at intervals) is obtained. The aggregate of such amounts is considered to be paid, credited, or distributed in such cases out of income of the estate or trust for its taxable year if it does not exceed the distributable income of the estate or trust for its taxable year. If the aggregate of such amounts does exceed the distributable income of the estate or trust for its taxable year, the portion of such amount paid, credited, or to be distributed to a legatee or beneficiary is considered income of the estate or trust for its taxable year which is paid, credited, or to be distributed in an amount which bears the same ratio to the amount of all distributable income as the amount so paid, credited, or to be distributed to the legatee or beneficiary bears to the aggregate of such amounts so paid, credited, or to be distributed to such legatees or beneficiaries for the taxable year of the estate or trust. The proportion stated in the preceding sentence applies only to legatees or beneficiaries of amounts which can be paid, credited, or distributed out of other than income of the estate or trust and, in computing such proportion, the amount of any gift, bequest, devise, or inheritance not to be paid, credited, or distributed at intervals is not to be included.

(3) Section 162 (d) (1) introduces a concept of distributable income. This is defined in that section as meaning (i) the net income of the estate or trust computed with the deductions allowed under subsections (b) and (c) of section 162 in the case of amounts paid, credited, or to be distributed to which section 162 (d) (1) does not apply, or (ii) the income of the estate or trust minus the deductions provided in subsections (b) and (c) of section 162 in the case of amounts paid, credited, or to be distributed to which section 162 (d) (1) does not apply, whichever is greater. "Net income," as thus used, means the statutory net income of the trust under the Internal Revenue Code before the application of section 162 (b) and (c) (but, as stated in the preceding sentence, such amount is to be reduced by the deductions allowed under subsections (b) and (c) of section 162 in the case of amounts to which section 162 (d) (1) does not apply) "Income," as thus used, must be determined in accordance with the following principles: First, such "income" means, in general, the amount which under the applicable law of estates and trusts is considered income available for distribution to the life tenant, legatee, or beneficiary, as the case may be. Second, there must

be eliminated from the income of the estate or trust, determined in accordance with the terms of the trust instrument and State law, items of income which are not includible in income of an individual for Federal income tax purposes. Therefore, the "income," referred to in clause (B) of section 162 (d) (1) may exceed net income and thus be treated as distributable income under section 162 (d) in cases where items which are deductible for Federal income tax purposes are, by the terms of the trust instrument or State law, not to be used to reduce income available for distribution but to be allocated to corpus.

(4) The application of section 162 (d) (1) in general, may be illustrated by the following example:

Example. Pursuant to the terms of the will of A, a trust is established on January 1, 1952, to pay $5,000 a year to B, and upon the death of B to pay the corpus and any accumulated income to his estate. The returns of the trust and of B are made on the calendar year basis. The trust instrument provides that the amount payable to B is to be paid out of income (after payment of trustees' commissions) or out of corpus to the extent income is insufficient. The receipts and expenditures of the trust for 1952 are as follows:

Taxable stock dividend	$1,000
Income from rents	3,000
Tax-exempt interest from State bonds	1,200
Deductible trustees' commissions	200
Other deductible expenditures	1,300

In accordance with the terms of the trust instrument stock dividends are to be allocated to corpus, and trustees' commissions are to be charged to income. However, the other expenditures indicated above ($1,300) are of a nature which under the terms of the trust instrument are to be charged to corpus. The distributable income of the trust to be deducted by it for 1952 and included in the beneficiary's income for such year is $2,800, the greater of the statutory net income or the available trust income includible in gross income, determined as follows:

Statutory Net Income (Prior to Application of Section 162 (b) and (c))

Gross income:	
Stock dividend	$1,000
Rents	3,000
	4,000
Deductions:	
Trustees' commissions	200
Other deductible expenses	1,300
	1,500
Net income	2,500

Trust Income Under Clause (B) of Section 162 (d) (1)

Income:	
Rents	$3,000
Interest from State bonds	1,200
	4,200
Expenses allocated to income: Trustees' commissions	200
Eliminating items not includible in gross income: Tax-exempt interest	1,200
	1,400
Income determined under section 162 (d) (1) (B)	2,800

(5) "Net income" and "income" for the purpose of section 162 (d) (1) also do not include income of a prior taxable year, even though such income may be considered income of the estate or trust for the current taxable year under section 162 (d) (2) This rule may be illustrated by the following example:

Example. Under the terms of a trust, established in 1935, the trustees are to accumulate the income thereof until A reaches his twenty-first birthday, and then are to pay A such accumulated income, and on each December 31 thereafter, are to pay B $5,000, out of income of the trust, if income is available, or, if not, out of corpus of the trust. A became 21 years of age on June 30, 1952. The returns of the trust and of A and B are made on the calendar year basis. Under section 162 (b), the income of the trust for that part of 1952 on and before June 30, 1952, is to be considered income of the trust for 1952 which is to be distributed currently to A. In computing the distributable income of the trust for 1952 which is to be considered distributed to B in payment of the $5,000 annuity, the amount of income for the first six months of 1952 which is considered to be currently distributable to A is to be deducted. Although under section 162 (d) (2) the amount of the income of the trust for the period July 1, 1951, through June 30, 1952, will be considered income of the trust for 1952 which is to be deducted by the trust and included in A's income for 1952 (see paragraphs (b) and (d) of this section), for the purposes of section 162 (d) (1) such amount is not to be deducted from the trust's income for 1952 in computing its distribuable income considered to be distributed to B and no account is to be taken of the income of the trust for the period July 1, 1951, through December 31, 1951.

(b) *Allocation among income beneficiaries and legatees.* (1) Section 162 (d) (2) applies in cases where income of the estate or trust for any period becomes payable on a date more than 65 days after the beginning of its taxable year. It applies in every case where income of the estate or trust is paid, credited, or to be distributed to a legatee, heir, or beneficiary, other than a legatee, heir, or beneficiary to whom paragraph (a) of this section applies or a legatee, heir, or beneficiary of a lump-sum gift, bequest, devise, or inheritance. This paragraph, and not paragraph (a) of this section, applies to income paid, credited, or to be distributed to a legatee who, in addition to any part of the principal of an estate, is entitled to receive any income during the administration of the estate or upon its termination, whether payment of such income is made in accordance with directions in the will, or for support as allowed under State law, or by the administrator to the residuary legatee in the ordinary course of administration. This rule, however, has no application in cases where income may be paid or credited, or is to be distributed under an obligation to pay an amount periodically at all events, whether or not income is available, as in the ordinary case of an annuity. Section 162 (d) (2) also has no application in determining the amount to be included in the income of the estate or trust under section 161 but applies only in determining the amount allowed as deductions under section 162 (b) and (c)

(2) Section 162 (d) (2) applies whether amounts are paid, credited, or to be distributed out of the income of the estate or trust for its current taxable year or out of the income for any period. It includes a rule for allocating income of the estate or trust to the legatees or beneficiaries in cases in which the income of a prior period is paid, credited, or to be distributed to the legatee or beneficiary during the taxable year of the estate or trust. In the absence of proof that any particular period of time is the source of an amount of income which becomes payable within the taxable year, the period from which such income is derived will be presumed to be a period ended with the date the income becomes payable. In such a case the year ended with the date the income becomes payable shall be considered the last 12 months of such period (whether or not other distributions under this paragraph have been made during such last 12 months) and the income which becomes payable shall be considered as derived from the most recently accumulated income for such period.

(3) As used in section 162, the term "income which becomes payable" means income to which the legatee, heir, or beneficiary has a present right, whether or not such income is actually paid. Such right may be derived from the directions in the trust instrument or will to make distributions of income at a certain date, or from the exercise of the fiduciary's discretion to distribute income, or from a recognized present right under the local law to obtain income or compel a distribution of income. Income is not considered to become payable within a taxable year where during the entire taxable year there is only a future right to such income. For example, under valid terms of a trust instrument, income received by a trust during its taxable year is to be accumulated until the twenty-first birthday of the beneficiary (or his prior death) at which time the accumulated income is to be distributed to the beneficiary (or his estate, as the case may be) In such case, the income of the trust received in any taxable year prior to the taxable year of the trust in which the date of distribution occurs (the beneficiary's twenty-first birthday or his prior death) is not income which becomes payable within such prior taxable year but is income which becomes payable in the taxable year of the trust in which the date of distribution occurs. In any case, income becomes payable at a date not later than the date it is actually paid for the use of the distributee.

(4) The application of section 162 (d) (2) in general, may be illustrated by the following examples:

Example (1). An existing trust makes its returns on the cash receipts and disbursements basis and on the basis of a calendar year accounting period. Under the terms of the trust and the local law (which allows accumulations) the income of the trust for the period of 12 months ended June 30 of each year is to be accumulated and payment made to the beneficiary on the last

day of such period (June 30). It is assumed that the entire net income of the trust (determined before the application of section 162 (b)) is available for distribution and that the trust receives $100 of such income each month during 1951 and 1952. For the calendar year 1952, the trust will include $1,200 in its income, which is its actual income for 1952 determined under section 161 and before taking the deductions under section 162. Under section 162 (d) (2) the trust income for the 12 months ending June 30, 1952, amounting to $1,200, which under the terms of the trust instrument is available for distribution on such date, is considered for the purposes of section 162 (b) as income for the taxable year 1952 and accordingly will be deducted by the trust for 1952. Assuming that the beneficiary makes his returns on the calendar year basis, he will include this amount deducted by the trust in 1952 in his income for 1952, unless he is permitted to exclude part or all of the income earned by the trust in the last six months of 1951 under the provisions of section 162 (d) (4). The same process will be repeated each year thereafter as long as the accounting periods and the distribution date remain the same.

Example (2). An estate which came into being on January 1, 1951, accumulates the income received (as is allowed under the local law) until June 30, 1952, at which time the executor distributes $6,000 of income to the residuary legatee. The balance of the accumulated income becomes payable under the local law on December 31, 1952, the date the administration of the estate is terminated, and a final distribution of $18,000 of income is then made to the residuary legatee. It is established that the estate, which was on a cash basis, received net income, which it accumulated during the administration of the estate, at the rate of $1,000 a month, but in making the distributions to the residuary legatee the executor did not attempt to identify such distributions with the income received during any particular period during the administration of the estate. Upon such facts, for the taxable year 1952, the distribution on June 30, 1952, of $6,000 will be presumed to be a distribution out of the most recently accumulated income of the estate, that is, for the first six months of 1952, and the final distribution of $18,000 on December 31, 1952, will be considered a distribution out of the income for the entire period of administration, of which the last 12 months is the calendar year 1952 and the most recently accumulated income is the $6,000 for the last six months of 1952. Accordingly, for 1952 the estate will take a deduction of $12,000 and the legatee will include the same amount (out of the total of $24,000 received) in his income, by reason of the distributions on June 30 and December 31, 1952.

(5) The rule of section 162 (d) (2) also applies in the case of a distribution out of income for a period which does not include any part of the current taxable year. Thus, in the case of a trust established on January 1, 1951, which accumulates the income in the first year of the trust and each year thereafter (more than 65 days after the close of the prior taxable year) distributes the prior year's accumulation, the 1951 accumulated income to be distributed in 1952 will be considered income of the trust for 1952 which is to be distributed in 1952.

(6) If the prior period, the income of which becomes payable in the taxable year, is a period of more than 12 months, then only the income of the last 12 months of such period is considered to be income which is to be distributed during the current taxable year. This rule may be illustrated by the following example:

Example. Under the terms of an existing trust with respect to which the local law allows accumulations, the trustee has discretion to either accumulate or distribute the income to the beneficiary. The income tax returns of the trust and the beneficiary are made on the calendar year basis. On April 1, 1953, the trustee distributes to the beneficiary all the income accumulated from January 1, 1950, through March 31, 1953. Pursuant to section 162 (d) (2), the amount of the income of the trust for the period April 1, 1952, through March 31, 1953, that is, for the last 12 months of the period of accumulation, is deductible under section 162 (c) in the return of the trust for the calendar year 1953, and is includible in the beneficiary's income tax return for that year, subject to the limitation provided in section 162 (d) (4). The distribution of the accumulated income will include the income of the trust for the last nine months of 1952 upon which the trust may have paid a tax for the year 1952, but such income is, if under the terms of the trust instrument and the local law the Federal income tax is a charge against such income, reduced by the amount of Federal income tax attributable to such income and paid by the trustee. If the deduction taken by the trust for the distribution to the beneficiary on April 1, 1953, exceeds the net income of the trust for the calendar year 1953, see section 162 (d) (4) and paragraph (d) of this section.

(c) *Distributions in first 65 days of taxable year* (1) Section 162 (d) (3) is designed to apportion amounts paid, credited, or to be distributed within the first 65 days of the taxable year of the estate or trust to that part of such first 65 days and the preceding taxable year to which such amounts are attributable.

(2) Section 162 (d) (3) (B) applies in cases described in section 162 (d) (1), that is, generally, in cases of annuities. If an annuity becomes payable in the first 65 days of the taxable year of the estate or trust, a proportionate part of the amount which thus becomes payable is considered payable on the last day of the preceding year. This proportionate part is that part of the amount which becomes payable within the first 65 days as the part of the interval not falling within the taxable year bears to the whole period of the interval. If, however, the part of the interval not falling within the taxable year (the year in which the amount becomes payable) is a period of more than 12 months, the interval is considered to begin on a date 12 months before the end of the preceding taxable year. Thus, if $4,250 is to be paid every two years on March 1, the period of the interval ending March 1, 1953, is considered to begin 12 months preceding December 31, 1952, since the part of the interval not falling within the taxable year 1953 (March 2, 1951, through December 31, 1952) is more than 12 months. Accordingly, the interval is considered to be the period January 1, 1952, through March 1, 1953, or 425 days, and the part of the interval not falling within the taxable year is considered to be the calendar year 1952, or 365 days. Therefore, of the $4,250 which becomes payable on March 1, 1953, 365/425 of such amount, or $3,650, is considered to be an amount to be distributed on December 31, 1952. The provisions of section 162 (d) (1) determine the extent to which the amount distributed on March 1 and the amount considered to be distributed on December 31 are paid, credited, or to be distributed out of income of the estate or trust for its taxable year.

(3) Section 162 (d) (3) (A) applies in the type of cases described in section 162 (d) (2) but only where income is paid, credited, or to be distributed within the first 65 days of the taxable year of the estate or trust. In such cases, if income of the estate or trust for a period beginning before the beginning of the taxable year becomes payable within the first 65 days of the taxable year, the income for the part of such period not falling within the taxable year is considered to be paid, credited, or distributed on the last day of the preceding taxable year. If the part of such period beginning before the beginning of the taxable year is more than 12 months, only the income of the last 12 months of such part is considered paid, credited, or to be distributed on the last day of the preceding taxable year. If the amount of income for any period paid, credited, or to be distributed to a legatee or beneficiary during the taxable year of the estate or trust is less than the total amount of income (not already paid, credited, or to be distributed to legatees or beneficiaries) for such period, such amount will be considered paid, credited, or to be distributed from the most recently accumulated income of the period. For example, a trust which makes its returns on the calendar year basis and which is to distribute the income of the trust, but not in excess of $5,000, to the beneficiary each February 28 received $500 of income each month during the period March 1, 1952, through February 28, 1953, or a total of $6,000. In such case, $1,000 of the $5,000 to be distributed to the beneficiary on February 28, 1953, will be considered to be distributed out of the income of the trust for 1953 (the income of the period January 1, 1953, through February 28, 1953) and $4,000 will be considered to have been distributed to the beneficiary on December 31, 1952, out of the income of the trust for 1952.

(d) *Treatment of excess deductions of estates and trusts.* (1) Section 162 (d) (4) is designed to avoid a form of double taxation which can arise through operation of section 162 (d) (2) and (3) (A). It becomes applicable only in cases where the deductions allowed to an estate or trust for a taxable year under section 162 (b) or (c) solely upon application of section 162 (d) (2) or (3) (A) exceed the net income of the estate or trust for such year, computed without the deductions allowed by reason of section 162 (d) (2) and (3) (A) The provisions of section 162 (d) (4) do not prevent the taxation of income distributed to legatees, heirs, or beneficiaries merely because the income may have been previously taxed to the estate or trust. See the example in subparagraph (3) of this paragraph.

(2) It is in the case of an estate which terminates its administration on a date

more than 65 days after the beginning of its final taxable year that section 162 (d) (4) will be applicable most frequently to eliminate the double taxation that can arise by reason of section 162 (d) (2). For example, the income of an estate during its several years of administration, amounting to $100 each month, was accumulated until the estate was closed on May 31, 1952, on which date the accumulated income was payable under the terms of the will or local law to B, the residuary legatee, together with or as a part of the residue of the estate. The return of the estate for the calendar year 1952 will include income of $500 from which there will be deducted under section 162 (c) pursuant to section 162 (d) (2) the sum of $1,200 (assuming that under the local law any income taxes paid by the estate with respect to the 1952 income are not chargeable to income) Since the estate is entitled to a deduction of $500 under section 162 (c) without the application of section 162 (d) (2) that is, for income received and distributed in the year 1952, only $700 of the $1,200 deduction is taken by the estate solely by reason of section 162 (d) (2) Thus, the deduction allowed the estate solely by reason of section 162 (d) (2) exceeds the net income of the estate for 1952 computed without such deduction by the amount of $700, which amount would be excluded from B's income for the year 1952. B's return for the calendar year 1952 would include only the income of $500 received by the estate in 1952.

(3) If a trustee is required, or permitted, under the terms of the trust to distribute in one year the income of a prior period, excess deductions of the type covered by section 162 (d) (4) also may arise by reason of section 162 (d) (2) in such a case. For example, the income of a trust for the calendar year 1952 amounted to $10,000 and was properly accumulated by the trustee until July 1, 1953, when only the income for the year 1952 was paid to the beneficiary, and no other distribution was made during the year 1953 or within the first 65 days of 1954. The net income of the trust for the year 1953, computed without the deduction allowed through the operation of section 162 (d) (2) amounted to only $8,000. The deduction of $10,000, being allowed solely by reason of section 162 (d) (2) exceeded the net income of the trust for 1953, computed without such deduction, by $2,000. Thus, section 162 (d) (4) operates so as to exclude from the beneficiary's return the amount of such excess deduction. The beneficiary, in his return for the calendar year 1953, would include $8,000 of the July 1, 1953, distribution, even though the trust may have paid taxes on such income for the year 1952.

(4) Excess deductions of an estate or trust solely by reason of section 162 (d) (3) (A) will not arise frequently, for the distribution of income within the first 65 days of a taxable year of an estate or trust will generally consist of income received by the estate or trust in the immediately preceding taxable year of the estate or trust. Thus, if on February 1, 1953, an estate or trust distributes the 1952 income to B, the deduction for such distribution is taken in the return of the estate or trust for the calendar year 1952, and in most cases the deduction allowed will be equal to the net income (before such deductions) for the year 1952. However, if the estate or trust income (as determined by the will, trust instrument, or local law) for the year 1952 payable to B on February 1, 1953, exceeded the net income of the estate or trust for 1952 before the application of section 162 (d) (3) (A) then section 162 (d) (4) would operate to exclude from B's income the amount of the excess deduction to the estate or trust. Excess deductions also can arise upon application of section 162 (d) (3) (A) in a case where a fiduciary of an estate or trust distributes within the first 65 days of its taxable year the income of a period not covering its immediately preceding taxable year. Thus, if a trustee who accumulated the income for the calendar years 1951 and 1952 distributes to B on March 1, 1953, the income of the year 1951 only, the trust in its return for the year 1952 will deduct the amount of income of the year 1951 distributed on March 1, 1953. If such deduction allowed to the trust exceeds the net income of the trust for the year 1952, computed without such deduction, B will exclude the amount of such excess from his return for the calendar year 1952.

(5) The deductions allowed to an estate or trust solely by reason of section 162 (d) (2) and (3) (A) are compared under the provisions of section 162 (d) (4) with the net income of the estate or trust computed without such deductions, except that in a case where the estate or trust in computing its net income for a taxable year is entitled to a deduction under section 162 (d) (1) (relating to amounts paid to annuitants), the amount of the deduction under section 162 (d) (1) shall be computed with the application of section 162 (d) (3) (A). Such application of section 162 (d) (3) (A) in computing the net income of an estate or trust for the purpose of section 162 (d) (4) in a case where section 162 (d) (1) is applicable is shown in the following example which also illustrates the manner in which excess deductions are treated when two or more beneficiaries are involved.

Example. (i) Under an existing trust the trustee in his discretion may either accumulate or distribute the income to the beneficiaries, A and B, who share equally in the income of the trust. The returns of the trust and of the beneficiaries are made upon the calendar year basis. Under the terms of the trust, the trustee is required to pay an annuity of $4,000 to C on April 1 of each year. During the year 1952 the trust had gross income of $9,000 and expenses of $1,000 which were deductible in computing the net income under the Internal Revenue Code and were chargeable against income under the terms of the trust instrument.

(ii) The following distributions were made by the trustee during 1952 and the first 65 days of 1953:

(*a*) Six thousand dollars was paid to A on April 1, 1952, $5,000 as his share of the trust income during the last nine months of 1951 and $1,000 as his share of the trust income during the first three months of 1952.

(*b*) Two thousand dollars was paid to A on November 1, 1952, out of income received by the trust after March 31, 1952.

(*c*) Three thousand dollars was paid to B on January 5, 1953, out of his share of trust income for 1953.

(*d*) Four thousand dollars was paid to C, the annuitant, on April 1, 1952.

(iii) Of the $15,000 distributed, the trust is allowed deductions of only $13,000 by reason of such distributions, since only $2,000 of the $4,000 paid to C is deductible by the trust inasmuch as the distributable income as defined in section 162 (d) (1) is only $2,000, that is, $3,000 less: $1,000 of the April 1, 1952, distribution to A, the $2,000 distribution to A on November 1, 1952, and the $3,000 distribution to B on January 5, 1953.

(iv) The amount of the deductions of the trust which is to be excluded under section 162 (d) (4) in computing the net incomes of A and B is $5,000 computed as follows:

(*a*) Without the application of section 162 (d) (2) and (3) (A), the following deductions would *not* have been taken by the trust:

(*1*) $5,000 paid to A on Apr. 1, 1952, out of 1951 income, and deductible under section 162 (d) (2)	$5,000
(*2*) Amount paid to B on Jan. 5, 1953, deductible for 1952 under section 162 (d) (3) (A)	3,000
(*3*) Total	8,000

(*b*) The net income, for the purpose of section 162 (d) (4), is computed without applying section 162 (d) (2) and (3) (A), except that in computing the deduction allowed under section 162 (d) (1) it is necessary to apply section 162 (d) (3) (A) in determining the amount of the deduction allowable to the trust under section 162 (d) (1). The net income so computed is $3,000, determined as follows:

(*1*) Net income before any deductions under section 162	$8,000
(*2*) Less deductions allowable other than under section 162 (d) (2) and (3) (A)	
(*i*) Paid to A on Apr. 1, 1952, out of 1952 income	1,000
(*ii*) Paid to A on Nov. 1, 1952, out of 1952 income	2,000
(*iii*) Portion of the $4,000 paid to C, the annuitant (the distributable income under section 162 (d) (1) being only $2,000 in view of the $3,000 paid to B within the first 65 days of 1953)	2,000
(*iv*) Total of deductions	5,000
(3) Net income for the purpose of section 162 (d) (4)	3,000

(*c*) The deductions of $8,000 (item (*a*) (3)) exceed the net income of $3,000 (item (*b*) (3)) (c) by $5,000. Such excess is excluded from the net income of A and B (the beneficiaries receiving the income in item (*a*)) in the following proportions:

(*1*) $\frac{5,000}{8,000}$ of $5,000 is excluded from A's income.

(2) $\frac{3,000}{8,000}$ of $5,000 is excluded from B's income.

(6) Section 162 (d) (4) has no application to a case where, without applying section 162 (d) (2) or (3) (A) the deductions of the estate trust under section 162 (b) or (c) by reason of distributions

of income exceed the net income of the estate or trust for the taxable year computed under the Internal Revenue Code without such deductions. For example, section 162 (d) (4) would not be applicable in the case of a trust which receives a deduction of $10,000 by reason of its distribution to the beneficiary during the taxable year of the entire trust income (determined under the trust and local law) received during the taxable year, even though the net income of the trust under the Code before such deduction amounted to less than $10,000.

§ 39.162-3 *Rules for the application of section 162 (a) in the case of trusts—* (a) *Limitation on charitable, etc., deduction of trusts with trade or business income.* (1) In computing the deduction allowable under section 162 (a) to a trust for any taxable year, no amount otherwise allowable under section 162 (a) as a deduction shall be allowed as a deduction with respect to income of the taxable year which is allocable to the trust's Supplement U business income for such year. For the purpose of this section, the term "Supplement U business income" means an amount equal to the amount which, if such trust were exempt from taxation under section 101 (6) would be computed as its unrelated business net income under section 422 and the regulations thereunder. For the purpose of such computation under section 422, the term "unrelated trade or business" includes any trade or business regularly carried on by such a trust, or by a partnership of which it is a member.

(2) Unless the facts clearly indicate the contrary, the deduction otherwise allowable under section 162 (a) is allocable to the Supplement U business income on the basis of the ratio which the Supplement U business income bears to the net income of the trust computed without any deduction under section 162.

(3) The application of this section may be illustrated by the following examples:

Example (1). The X trust has net income of $50,000 computed without any deduction under section 162. There is included in this amount a net profit of $30,000 from the operation of a trade or business. The trustee is required to pay one-half of the net income to A, an individual, and the balance of the net income to the Y charity, an organization described in section 23 (o) (2). The trustee pays each beneficiary $25,000. Under these facts, the Supplement U business income of the trust (computed after the deduction allowable under section 422 (a) (9) for charitable contributions) is $25,500. The deduction otherwise allowable under section 162 (a) is $25,000, the amount paid to the Y charity. The portion thereof allocable to the Supplement U business income and therefore disallowed as a deduction is $12,750, that is, an amount which bears the same ratio to $25,000 as $25,500 bears to $50,000.

Example (2). Assume the same facts as in example (1), except that the trustee has discretion as to the portion of the net income to be paid to each beneficiary, and the trustee pays $40,000 to A and $10,000 to the Y charity. The deduction otherwise allowable under section 162 (a) is $10,000. The portion thereof allocable to the Supplement U business income and therefore disallowed as a deduction is $5,100, that is, an amount which bears the same ratio to $10,000 as $25,500 bears to $50,000.

Example (3). Assume the same facts as in example (1), except that the terms of the trust instrument require the trustee to pay to the Y charity the net income, if any, derived from the trade or business, and to pay to A all the net income derived from other sources. The trustee pays $30,000 to the Y charity and $20,000 to A. The deduction otherwise allowable under section 162 (a) is $30,000. Under the facts in this case, $25,500 of the amount paid to the Y charity is allocable to the Supplement U business income and is therefore disallowed as a deduction.

(b) *Limitation on charitable, etc., deduction of trusts engaged in prohibited transactions.* (1) In the case of a trust which has engaged in any prohibited transaction (as described in section 162 (g) (2) (B)) the amount otherwise allowable under section 162 (a) as a deduction shall not exceed 15 percent of the net income of such trust (computed without the benefit of section 162 (a)) for any taxable year subsequent to the taxable year in which there is mailed to it a notice in writing by the Commissioner that it has engaged in such prohibited transaction. Such notification by the Commissioner shall be by registered mail to the last known address of the fiduciary. However, notwithstanding the requirement of notification by the Commissioner, such limitation (on the amount otherwise allowable under section 162 (a) as a deduction) shall apply with respect to any taxable year, if such trust during or prior to such taxable year commenced the prohibited transaction with the purpose of diverting such income or corpus from the purposes described in section 162 (a) and such transaction involved a substantial part of such income or corpus. See examples under §§ 39.162-4 and 39.3813-1.

(2) A trust whose deduction under section 162 (a) has been limited by reason of the provisions of section 162 (g) (2) (A) may file, in any taxable year following the taxable year in which notice of limitation of deduction was issued, a claim for allowance of unlimited deduction under section 162 (a). This claim shall be filed with the district director of internal revenue for the internal revenue district in which the fiduciary resides or has his principal place of business. The claim must contain or have attached to it an affidavit by the fiduciary that the trust will not knowingly again engage in a prohibited transaction.

(3) If the Commissioner is satisfied that the trust will not knowingly again engage in a prohibited transaction, he shall so notify the trust in writing. In such case the trust will be allowed unlimited deduction under section 162 (a) (subject to the provisions of section 162 (g)) with respect to taxable years subsequent to the taxable year in which such claim is filed. Section 162 (g) (2) (C) contemplates that a trust whose charitable, etc., deduction has been limited as prescribed therein shall be subject to such limitation for at least one full taxable year.

(c) *Limitation on charitable, etc., deduction of trusts accumulating income.* (1) The amount otherwise allowable under section 162 (a) as a deduction shall be limited to the amount actually paid out during the taxable year and shall not exceed 15 percent of the net income of the trust (computed without the benefit of section 162 (a)), if the amounts permanently set aside, or to be used exclusively, for the charitable and other purposes described in section 162 (a) during the taxable year or any prior taxable year (including taxable years beginning before the effective date of section 162 (g) (4)) and not actually paid out by the end of the taxable year are unreasonable. Amounts accumulated out of income for purposes described in section 162 (a) become unreasonable when more income is accumulated than is needed, or when the duration of the accumulation is longer than is needed, in order to carry out the charitable or other purpose described in section 162 (a) for which such amounts were set aside. Furthermore, such limitation on the deduction otherwise allowable under section 162 (a) shall apply if amounts accumulated out of income for purposes described in section 162 (a) are used to a substantial degree for purposes other than those described in section 162 (a), or if such amounts are invested in such a manner as to jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries.

(2) For the purpose of section 162 (g) (4) the term "income" means gains, profits, and income determined under the principles applicable in determining the earnings or profits of a corporation. The amount accumulated out of income during the taxable year or any prior taxable year shall be determined under the principles applicable in determining the accumulated earnings or profits of a corporation. In determining the reasonableness of an accumulation out of income, there will be disregarded the following: (i) The accumulation of gain upon the sale or exchange of a donated asset to the extent that such gain represents the excess of the fair market value of such asset when acquired by the trust over its substituted basis in the hands of the organization; (ii) the accumulation of gain upon the sale or exchange of property held for the production of investment income, such as dividends, interest, and rents, where the proceeds of such sale or exchange are within a reasonable time reinvested in property acquired and held in good faith for the production of investment income.

(3) Whether the conditions specified in subparagraphs (A), (B), and (C) of section 162 (g) (4) are present in any case must be determined from all the facts. The conditions specified in section 162 (g) (4) (A), (B) and (C) may result from the use of only one trust or of a chain of two or more organizations.

(4) A trust whose deduction under section 162 (a) has been limited by reason of the provisions of section 162 (g) (4) may file a claim for allowance of unlimited deduction under section 162 (a). This claim shall be filed with

the district director of internal revenue for the internal revenue district in which the fiduciary resides or has his principal place of business. The claim must contain or be accompanied by information or evidence showing that the circumstances that caused the limitation on deduction prescribed under section 162 (g) (4) no longer exist, and an affidavit by the fiduciary that the trust will not knowingly again violate the terms of such section. Section 162 (g) (4) contemplates that a trust whose charitable, etc., deduction has been limited as prescribed therein shall be subject to such limitation for at least one full taxable year.

(5) In the case of a trust the deduction under section 162 (a) of which has been limited solely by reason of the provisions of section 162 (g) (4) deductions otherwise allowable under section 23 (o) (2) 23 (q) (2) 162 (a) or 505 (a) (2) for gifts or contributions made to such a trust in trust for charitable, etc., purposes, shall not be disallowed.

§ 39.162-4 *Disallowance to donors of certain charitable, etc., deductions for gifts made in trust.* (a) No gift or contribution which would otherwise be allowable as a charitable or other deduction under section 23 (o) (2) 23 (q) (2) 162 (a) or 505 (a) (2) shall be allowed as a deduction if made in trust and, in the taxable year of the trust in which the gift or contribution is made, the deduction allowed the trust under section 162 (a) is limited by reason of the provisions of section 162 (g) (2) (A)

(b) The prohibited transactions enumerated in section 162 (g) (2) (B) are in addition to and not in limitation of the restrictions contained in section 23 (o) (2) 23 (q) (2) 162 (a) or 505 (a) (2) A deduction may not be allowed in view of the general provisions of those sections, even though the trust has not engaged in any of the prohibited transactions referred to in section 162 (g) (2) (B) Thus, if the donor or the fiduciary of the trust enters into a transaction with the trust, such transaction will be closely scrutinized to ascertain whether the contribution is in fact made for the stated exempt purposes.

(c) If a trust, which receives a gift or contribution for charitable, etc., purposes is not entitled to the unlimited deduction under section 162 (a) because it engaged in a prohibited transaction with the purpose of diverting its income or corpus from the purposes described in section 162 (a), and such transaction involved a substantial part of such income or corpus, and if the taxable year of the trust during which such gift or contribution is made is the same as, or is prior to, the taxable year of the trust in which such transaction occurred, then a deduction by the donor with respect to the gift or contribution shall not be disallowed under paragraph (a) of this section unless the donor (or any member of his family if the donor is an individual) is a party to such prohibited transaction. For the purpose of the preceding sentence, the members of an individual donor's family include only his brothers and sisters, whether by whole or half blood, spouse, ancestors, and lineal descendants. See § 39.3813-3 for disallowance of certain charitable, etc., deductions otherwise allowable under section 162 (a).

(d) The application of this section may be illustrated by the following example:

Example. Under the terms of an irrevocable trust established by A in 1949, the trustees were to pay one-half of the income of the trust to A's wife for life, and the trustees were given discretion either to accumulate or distribute the remaining one-half of the income to a specified charitable beneficiary. Upon the death of the wife, the entire corpus was to be paid to the named charity. The trust makes its income tax returns on the basis of the calendar year. For 1949, A takes a charitable deduction for the amount of the gift in trust to the charity. In 1952, 1953, 1954, and 1955, A makes further contributions to the trust and takes charitable deductions for such years under section 23 (o) (2). In 1953, 1954, and 1955, B (not a member of A's family) makes contributions to the trust for its designated charitable purpose and takes charitable deductions for such years. In 1953, the trust commences purposely to divert income and corpus which had been set aside for its charitable purpose and to turn such income and corpus over to A, the creator of the trust, and a substantial amount of such income and corpus is so diverted by the close of the taxable year 1954. For 1953 and subsequent taxable years, the deduction allowed the trust under section 162 (a) is limited by reason of the provisions of section 162 (g) (2) (A). Both A and B are disallowed any charitable deduction for their charitable contributions made during 1955 to the trust. Moreover, the charitable deduction taken by A for contributions to the trust in the years 1953 and 1954 would also be disallowed since A was a party to the prohibited transaction. If the facts and surrounding circumstances indicate that the contribution in 1952 by A was for the purpose of the prohibited transaction, then the charitable deduction for the year 1952 shall also be disallowed with respect to A, since the prohibited transaction would then have commenced with the making of such contribution and the deduction allowed the trust under section 162 (a) would then be limited for 1952 by reason of the provisions of section 162 (g) (2) (A).

§ 39.163 *Statutory provisions; estates and trusts; credits against net income.*

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, in lieu of the exemptions under section 25 (b) (1), a credit of $600 against net income, and a trust shall be allowed, in lieu of the exemptions 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.

(c) *Credits of estate or trust and beneficiary in case of bond premium.* If the estate or trust elects under section 125 to treat the premium on bonds, the interest on which is allowable as a credit under section 25 (a) (1) or (2), as amortizable,

(1) For the purposes of subsection (a) (2), the credits allowed by section 25 (a) shall be reduced as provided in section 125 (a) (3);

(2) For the purposes of subsection (b), the proportionate share of the legatee, heir, or beneficiary of such interest shall be his proportionate share of such interest (determined without regard to this paragraph) reduced by so much of the deduction under section 23 (v) as is attributable to such share. The remainder of such deduction, for the purposes of the last sentence of subsection (b), shall be applied in reduction of such credits of the estate or trust.

[Sec. 163 as amended by sec. 126 (d), Rev. Act 1942; sec. 10 (e), Individual Income Tax Act 1944; sec. 102 (b) (6), Rev. Act 1945; sec. 202 (d), Rev. Act 1948]

§ 39.163-1 *Credits to estate, trust, or beneficiary*—(a) *Credits allowed estates and trusts for normal tax and surtax purposes.* An estate is allowed, in lieu of the exemptions allowed by section 25 (b) (1) a credit of $600 against net income for both normal tax and surtax purposes. For proration of such credit in the case of a fractional part of a year resulting from termination of the taxable period by the Commissioner under section 146, see § 39.47-1. A trust is allowed, in lieu of the exemptions under section 25 (b) (1) a credit of $100 against net income for both normal tax and surtax purposes. 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 and its instrumentalities. (For reduction of credits on account of amortizable bond premium, see § 39.125 (c)-2.)

(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 its instrumentalities 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. No additional exemption is allowable to the beneficiary of a trust by reason of the receipt of income

from such trust. For reduction of credits on account of amortizable bond premium see § 39.125 (c)-2.

§ 39.164-165 *Statutory provisions; estates and trusts; different taxable years; employees' trusts.*

SEC. 164. *Different taxable years.* If the taxable year of a legatee, heir, or 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, 1939) ending within or with his taxable year.

[Sec. 164 as amended by sec. 111 (d), Rev. Act 1942]

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 his employees or their beneficiaries shall not be taxable under this supplement and no other provision of this supplement shall apply with respect to such trust or to its beneficiary—

(1) If contributions are made to the trust by such employer, or employees, or both, for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) If under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries 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 or their beneficiaries;

(3) If the trust, or two or more trusts, or the trust or trusts and annuity plan or plans are designated by the employer as constituting parts of a plan intended to qualify under this subsection which benefits either—

(A) 70 per centum or more of all the employees, or 80 per centum or more of all the employees who are eligible to benefit under the plan if 70 per centum or more of all the employees are eligible to benefit under the plan, excluding in each case employees who have been employed not more than a minimum period prescribed by the plan, not exceeding five years, employees whose customary employment is for not more than twenty hours in any one week, and employees whose customary employment is for not more than five months in any calendar year, or

(B) Such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees;

and

(4) If the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

(5) A classification shall not be considered discriminatory within the meaning of paragraph (3) (B) or (4) of this subsection merely because it excludes employees the whole of whose remuneration constitutes "wages" under section 1426 (a) (1) (relating to the Federal Insurance Contributions Act) or merely because it is limited to salaried or clerical employees. Neither shall a plan be considered discriminatory within the meaning of such provisions merely because the contributions or benefits of or on behalf of the employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees, or merely because the contributions or benefits based on that part of an employee's remuneration which is excluded from "wages" by section 1426 (a) (1) differ from the contributions or benefits based on employee's remuneration not so excluded, or differ because of any retirement benefits created under State or Federal law.

(6) A plan shall be considered as meeting the requirements of paragraph (3) of this subsection during the whole of any taxable year of the plan if on one day in each quarter it satisfied such requirements.

(b) *Taxability of beneficiary.* The amount actually distributed or made available to any distributee by any such trust shall be taxable to him, in the year in which so distributed or made available, under section 22 (b) (2) as if it were an annuity the consideration for which is the amount contributed by the employee, except that if the total distributions payable with respect to any employee are paid to the distributee within one taxable year of the distributee on account of the employee's separation from the service, the amount of such distribution to the extent exceeding the amounts contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months. Where such total distributions include securities of the employer corporation, there shall be excluded from such excess the net unrealized appreciation attributable to that part of the total distributions which consists of the securities of the employer corporation so distributed. The amount of such net unrealized appreciation and the resulting adjustments to basis of the securities of the employer corporation so distributed shall be determined in accordance with regulations which shall be prescribed by the Secretary. For purposes of this subsection, the term "securities" means only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form, and the term "securities of the employer corporation" includes securities of a parent or subsidiary corporation (as defined in section 130A (d) (2) and (3)) of the employer corporation. In no event shall the amount actually distributed or made available to any distributee include net unrealized appreciation in securities of the employer corporation attributable to the amount contributed by the employee. Such net unrealized appreciation and the resulting adjustments to basis of such securities shall also be determined in accordance with regulations which shall be prescribed by the Secretary.

(c) *Treatment of beneficiary of trust not exempt under subsection* (a). Contributions to a trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under section 165 (a) shall be included in the gross income of an employee for the taxable year in which the contribution is made to the trust in the case of an employee whose beneficial interest in such contribution is nonforfeitable at the time the contribution is made.

(d) *Certain employees' annuities.* Notwithstanding subsection (c), or any other provision of this chapter, a contribution to a trust by an employer shall not be included in the income of the employee in the year in which the contribution is made if—

(1) Such contribution is to be applied by the trustee for the purchase of annuity contracts for the benefit of such employee;

(2) Such contribution is made to the trustee pursuant to a written agreement entered into prior to October 21, 1942, between the employer and the trustee, or between the employer and employee; and

(3) Under the terms of the trust agreement the employee is not entitled during his lifetime, except with the consent of the trustee, to any payments under annuity contracts purchased by the trustee other than annuity payments.

The amount so contributed by the employer shall not constitute consideration paid by the employee for such annuity contract in determining the amount of annuity payments required to be included in his gross income under section 22 (b) (2); except that if the tax imposed by this chapter for any taxable year beginning before January 1, 1949, has been paid by the employee with respect to such contribution for such year, and not credited or refunded, the amount so contributed for such year shall constitute consideration paid by the employee for such annuity contract. This subsection shall have no application with respect to amounts contributed to a trust after June 1, 1949, if the trust on such date was exempt under subsection (a). For the purposes of this subsection, amounts paid by an employer for the purchase of annuity contracts which are transferred to the trustee shall be deemed to be contributions made to a trust or trustee and contributions applied by the trustee for the purchase of annuity contracts; the term "annuity contracts purchased by the trustee" shall include annuity contracts so purchased by the employer and transferred to the trustee; and the term "employee" shall include only a person who was in the employ of the employer, and was covered by the agreement referred to in paragraph (2), prior to October 21, 1942.

[Sec. 165 as amended by sec. 218, Rev. Act 1939; sec. 162 (a), Rev. Act 1942; sec. 5 (a), Public Law 378 (81st Cong.); sec. 335, Rev. Act 1951; sec. 1, Public Law 589 (82d Cong.)]

SEC. 162. *Pension trusts [Revenue Act of 1942].* * * *

(d) *Taxable years to which amendments applicable.* The amendments made by this section shall be applicable as to both employer and employees only with respect to taxable years of the employer beginning after December 31, 1941, except that—* * *

(2) A stock bonus, pension, profit-sharing, or annuity plan—* * *

(B) put into effect after December 31, 1944, shall be considered as satisfying the requirements of section 165 (a) (3), (4), (5) and (6) for the period beginning with the date on which it was put into effect and ending with the 15th day of the third month following the close of the taxable year of the employer in which the plan was put in effect, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period.

[Sec. 162 (d) (2) as amended by sec. 2 (b), Pub. Law 511 (78th Cong.)]

§ 39.165-1 *Employees' trusts*—(a) *In general.* (1) In order that a trust may be exempt under section 165 (a) it must be part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries. The trust must be formed and availed of solely to aid in the proper execution of a plan which is a definite written program and arrangement communicated to the employees, solely designed and applied to enable such employees or their beneficiaries to share in the capital or profits of such employer's trade or business or to provide for the livelihood of such employees

or their beneficiaries after the retirement of such employees. As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 3797 (a) (20)

(2) A pension plan within the meaning of section 165 (a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of section 165 (a) be considered a pension plan if under the plan either the benefits payable to the employee or the required contributions by the employer can be determined actuarially. A profit-sharing plan, on the other hand, is a plan established and maintained by an employer to provide for the participation in his profits, by his employees or their beneficiaries, based on a definite predetermined formula for determining the profits to be shared and a definite predetermined formula for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, or severance of employment. A formula for determining the profits to be shared is definite, for example, if it provides for a contribution equal to (i) a specified percentage of the annual profits, (ii) a specified percentage of the sum of dividend commitments plus a fixed amount with an over-all limitation, or (iii) a specified percentage of the annual profits not to exceed a specified percentage of the salaries of the participants or their contributions, if any, to the fund. A formula for distributing the accumulated funds among the participants is definite, for example, if it provides for a distribution in proportion to the basic compensation of each participant. A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to that of a profit-sharing plan except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. Such a plan, with respect to determining and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, is subject to the same requirements as in the case of a profit-sharing plan. A stock bonus, pension, or profit-sharing plan, as used in section 165 (a) does not include any plan which is primarily a dismissal wage plan.

(3) The term "plan" implies a permanent as distinguished from a temporary program. While the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, if the plan is abandoned for any cause other than business necessity within a few years after it has taken effect, this will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. Especially will this be true in the case of a pension plan under which pensions were fully funded for the highly paid employees or others in favor of whom discrimination is prohibited under section 165 (a), and which was abandoned soon after the pensions for such favored employees had been provided. The permanency of the plan will be indicated by all of the surrounding facts and circumstances, including the likelihood of the employer's ability to continue contributions as provided under the plan. In the event a plan is abandoned, the employer should promptly notify the district director of internal revenue (Commissioner, before January 1, 1954), stating the circumstances which led to the discontinuance of the plan.

(4) If the plan is so designed as to amount to a subterfuge for the distribution of profits to shareholders, even if other employees who are not shareholders are included under the plan, it will not qualify as a plan for the exclusive benefit of employees. The plan must benefit the employees in general, although it need not provide benefits for all of the employees. Among the employees to be benefited may be persons who are officers and shareholders. However, a plan is not for the exclusive benefit of employees in general if it discriminates either in eligibility requirements, contributions, or benefits by any device whatever in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees. See section 165 (a) (3) (4) and (5) Neither is a stock bonus or profit-sharing plan for the exclusive benefit of employees in general if the funds therein may be used to relieve the employer from contributing to a pension plan operating concurrently and covering the same employees. All of the surrounding and attendant circumstances and the details of the plan will be indicative of whether it is a bona fide stock bonus, pension, or profit-sharing plan for the exclusive benefit of employees in general. The law is concerned not so much with the form of any plan as it is with its effects in operation. For example, in section 165 (a) (5) the law specifies certain provisions, which of themselves are not discriminatory, but this does not mean that a plan containing these provisions may not be discriminatory in actual operation.

(5) A plan is for the exclusive benefit of employees or their beneficiaries even though it may cover former employees as well as present employees and employees who are temporarily on leave, as, for example, in the military or naval forces. A plan covering only former employees may qualify under section 165 (a) if it complies with the provisions of section 165 (a) (3) (B) with respect to coverage, and section 165 (a) (4) with respect to contributions and benefits, as applied to all of the former employees. The term "beneficiaries" of an employee within the meaning of section 165 includes the estate of the employee, dependents of the employee, persons who are the natural objects of the employee's bounty, and any persons designated by the employee to share in the benefits of the plan after the death of the employee.

(6) No specific limitations are provided in section 165 (a) with respect to investments which may be made by the trustees of a trust qualifying under section 165 (a) The contributions may be used by the trustees to purchase any investments permitted by the trust agreement, to the extent allowed by local law. Where, however, the trust funds are invested in stock or securities of the employer, full disclosure must be made of the reasons for such arrangement and of the conditions under which such investments are made in order that a determination may be made whether the trust serves any purpose other than constituting part of a plan for the exclusive benefit of employees.

(b) *Portions of years; affiliated corporations.* An exempt status must be maintained throughout the entire taxable year of the trust in order for the trust to obtain any exemption for such year. But see section 165 (a) (6) and § 39.165-3. A trust forming part of a plan of affiliated corporations for their employees may be exempt if all the requirements are otherwise satisfied.

(c) *Proof of exemption.* Every trust claiming exemption must prove its right thereto by filing with the district director of internal revenue for the internal revenue district in which the trust is located (Commissioner if filed before January 1, 1954) the information required under § 39.23 (p)-2 in order to show that the trust forms part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries, which plan meets the requirements of section 165 (a). Such information must be filed for each taxable year of the trust with respect to which this section is applicable, except that, where the information required by § 39.23 (p)-2 for a particular taxable year has been filed by the employer and he so notifies the trustee, the trustee, in lieu of the information required under § 39.23 (p)-2, may file with the district director (Commissioner if filed before January 1, 1954) the following information: (1) The names and addresses of the parties to the trust agreement and the date thereof; (2) the taxable year involved; (3) a copy of the notification from the employer with respect to the filing of such information; (4) the office of the district director of internal revenue in which the employer

files his returns; and (5) a request for exemption of the trust under section 165 (a)

§ 39.165-2 *Impossibility of diversion under the trust instrument*—(a) *In general.* Under section 165 (a) (2) a trust is not exempt unless under the trust instrument it is impossible (in the taxable year and at any time thereafter prior to the satisfaction of all liabilities to employees or their beneficiaries 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 or their beneficiaries. 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 nonexempt 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 it must be impossible for the trust funds to be used or diverted for purposes other than for the exclusive benefit of his employees or their beneficiaries. As used in section 165 (a) (2) the phrase "purposes other than for the exclusive benefit of his employees or their beneficiaries" includes all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries covered by the trust.

(b) *Meaning of "liabilities"* The intent and purpose in section 165 (a) (2) of the phrase "prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust" is to permit the employer to reserve the right to recover at the termination of the trust, and only at such termination, such balance in the trust as is due to erroneous actuarial computations during the previous life of the trust. A balance due to an "erroneous acturial computation" is the surplus arising because actual requirements differ from the expected requirements based upon previous actuarial valuations of liabilities or determinations of costs of providing pension benefits under the plan in accordance with reasonable assumptions as to mortality, interest, etc., and correct procedures relating to the method of funding, all as made by a careful person skilled in calculating the amounts necessary to satisfy pecuniary obligations of such a nature. For example, a trust has accumulated assets of $1,000,000 at the time of liquidation, determined by acceptable actuarial procedures using reasonable assumptions as to interest, mortality, etc., as being necessary to provide the benefits in accordance with the provisions of the plan. Upon such liquidation it is found that $950,000 will satisfy all of the liabilities under the plan. The surplus of $50,000 arises, therefore, because of the difference between the amounts actuarially determined and the amounts actually required to satisfy the liabilities. This $50,000, therefore, is the amount which may be returned to the employer as the result of an erroneous actuarial computation. If, however, the surplus of $50,000 had been accumulated as a result of a change in the benefit provisions or in the eligibility requirements of the plan, the $50,000 could not revert to the employer because such surplus would not be the result of an erroneous actuarial calculation. The term "liabilities" as used in section 165 (a) (2) includes 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 nonemployee) to recover any amounts other than such amounts as remain in the trust because of "erroneous actuarial computations" after the satisfaction of all 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.

§ 39.165-3 *Requirements as to coverage.* (a) (1) In order to insure that stock bonus, pension, and profit-sharing plans are utilized for the welfare of employees in general, and to prevent the trust device from being used for the principal benefit of shareholders, officers, persons whose principal duties consist in supervising the work of other employees, or highly paid employees, or as a means of tax avoidance, a trust will not be exempt unless it is part of a plan which satisfies the coverage requirements of section 165 (a) (3) The percentage requirements in section 165 (a) (3) (A) refer to a percentage of all the active employees, including employees temporarily on leave, such as those in the armed forces of the United States, if such employees are eligible under the plan.

(2) The application of section 165 (a) (3) (A) may be illustrated by the following example:

Example. An employer adopts a plan at a time when he has 1,000 employees. The plan provides that all full-time employees who have been in the employment for a period of two years and have reached the age of 30 shall be eligible to participate. The plan also requires the participating employees to agree to contribute 3 percent of their monthly pay. At the time the plan is made effective 100 of the 1,000 employees had not been in the employment for a period of two years. Fifty of the employees were seasonal employees whose customary employment was for not more than five months in any calendar year. Twenty-five of the employees were part-time employees whose customary employment was for not more than 20 hours in any one week. One hundred and fifty of the full-time employees who had been employed for two years or more had not yet reached age 30. Section 165 (a) (3) (A) will be met if 540 employees are covered by the plan, as shown by the following computation:

(i) Total employees with respect to which the percentage requirements are applicable (1,000 minus 175 (100 plus 50 plus 25))	825
(ii) Employees not eligible to participate because of age requirements	150
(iii) Total employees eligible to participate	675
(iv) Percentage of employees in item (i) eligible to participate	.81+
(v) Minimum number of participating employees to qualify the plan (80 percent of 675)	540

If only 70 percent, or 578, of the 825 employees satisfied the age and service requirements, then 462 (80 percent of 578) participating employees would satisfy the percentage requirements.

(b) If a plan fails to qualify under the percentage requirements of section 165 (a) (3) (A) it may still qualify under section 165 (a) (3) (B) provided always that (as required by section 165 (a) (3) and (4)) the plan's eligibility conditions, benefits, and contributions do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees.

(c) Section 165 (a) (5) sets out certain classifications that will not in themselves be considered discriminatory. However, those so designated are not intended to be exclusive. Thus, plans may qualify under section 165 (a) (3) (B) which are limited to employees who have reached a designated age or have been in the employment for a designated number of years or are employed in certain designated departments or are in other classifications: *Provided,* That the effect of covering only such employees is not to discriminate in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees. For example, if there are 1,000 employees, and the plan is written for only salaried employees, and consequently only 500 employees are covered, that fact alone will not justify the conclusion that the plan does not meet the coverage requirements of section 165 (a) (3) (B) provided the classification as established does not discriminate in favor of shareholders, officers, employees whose principal duties consist in supervising the work of other employees, and the highly paid employees. If a contributory plan is offered to all of the employees, but the requirement of contribution by the employee participants is so burdensome as to make the plan acceptable only to the highly paid employees, the classification will be considered discriminatory in favor of such highly paid employees.

(d) Section 165 (a) (5) contains a provision to the effect that a classification shall not be considered discriminatory within the meaning of section 165 (a) (3) (B) merely because there are excluded from the plan employees the whole of whose annual remuneration constitutes wages under section 1426 (a) (1) (for purposes of the Federal Insurance Contributions Act) This provision, in conjunction with section 165 (a) (3) (B) is intended to permit the qualification of plans which supplement the social security program. A classification which excludes all employees the whole of whose remunerations constitutes wages under section 1426 (a) (1) or a classification including such employees in a plan under which the contributions or benefits based on that part of an employee's remuneration which is excluded from wages under section 1426 (a) (1) differs from the contributions or benefits based on the employee's remuneration not so excluded, will not be a discriminatory classification merely because of such exclusion or difference. However, in making his determination with respect to discrimination in classification under section 165 (a) (3) (B) the Commissioner will consider whether the total benefits resulting to each employee under the plan and under the Social Security Act, or under the Social Security Act only, establish an integrated and correlated retirement system satisfying the tests of section 165 (a) Thus, a classification of employees under any plan which results in relatively or proportionately greater benefits for employees earning above any specified salary amount or rate than for those below such salary amount or rate may be found to be discriminatory within the meaning of section 165 (a) (3) (B) unless such relative or proportionate differences in benefits as between employees resulting from such classification are approximately offset by the retirement benefits provided by the Social Security Act. For this purpose the total Social Security Act benefits of an employee, in view of the supplementary benefits provided by such law, may be considered as 150 percent of the primary insurance benefit provided thereby. A plan supplementing the Social Security Act and excluding employees the whole of whose annual remuneration constitutes wages under section 1426 (a) (1) will not, however, be deemed discriminatory merely because for administrative convenience, it provides a reasonable minimum benefit not to exceed $20 a month. Similar considerations, to the extent applicable in any case, will govern classifications under plans supplementing the benefits provided by other Federal or State laws. See section 165 (a) (5)

(e) An employer may designate several trusts or a trust or trusts and an annuity plan or plans as constituting one plan which is intended to qualify under section 165 (a) (3) in which case all of such trusts and plans taken as a whole may meet the requirements of such section. The fact that such combination of trusts and plans fails to qualify as one plan does not prevent such of the trusts and plans as qualify from meeting the requirements of section 165 (a).

(f) It is provided in section 165 (a) (6) that a plan will satisfy the requirements of section 165 (a) (3), if on at least one day in each quarter of the taxable year of the plan it satisfies such requirements. This makes it possible for a new plan requiring contributions from employees to qualify if by the end of the quarter-year in which the plan is adopted it secures sufficient contributing participants to meet the requirements of section 165 (a) (3). It also affords a period of time in which new participants may be secured to replace former participants, so as to meet the requirements of either subparagraph (A) or (B) of section 165 (a) (3)

§ 39.165-4 *Discrimination as to contributions or benefits.* (a) To be exempt under section 165 (a) a trust must not only meet the coverage requirements of section 165 (a) (3), but, as provided in section 165 (a) (4), it must also be part of a plan under which there is no discrimination in contributions or benefits in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees as against other employees whether within or without the plan. Funds in a stock bonus or profit-sharing plan arising from forfeitures on termination of service, or other reason, must not be allocated to the remaining participants in such a manner as will effect the prohibited discrimination. With respect to forfeitures in a pension plan, see § 39.165-1 (a) Section 165 (a) (5) sets out certain provisions which will not in and of themselves be discriminatory within the meaning of section 165 (a) (3) or (4). See § 39.165-3. Thus, a plan will not be considered discriminatory merely because the contributions or benefits bear a uniform relationship to total compensation, or to the basic or regular rate of compensation, or merely because the contributions or benefits based on that part of the annual compensation of employees subject to the Federal Insurance Contributions Act differ from the contributions or benefits based on the excess of such annual compensation over such part. The exceptions specified in section 165 (a) (5) are not an exclusive enumeration, but a recital of provisions frequently encountered which will not of themselves constitute forbidden discrimination in contributions or benefits. Variations in contributions or benefits may be provided so long as the plan, viewed as a whole for the benefit of employees in general, with all its attendant circumstances, does not discriminate in favor of employees within the enumerations with respect to which discrimination is prohibited. Thus, benefits in a stock bonus or profit-sharing plan which vary by reason of a distribution formula which takes into consideration years of service, or other factors, are not prohibited unless they discriminate in favor of such employees.

(b) A plan which excludes employees, the whole of whose remuneration constitutes wages under section 1426 (a) (1) (relating to the Federal Insurance Contributions Act) or a plan in which the contributions or benefits based on that part of an employee's remuneration which is excluded from wages under such law differs from contributions or benefits based on the employee's remuneration not so excluded, or a plan in which the contributions or benefits differ because of any retirement benefit created under State or Federal law, will not be discriminatory because of such exclusion or difference, provided the total benefits resulting under the plan and under such law establish an integrated and correlated retirement system satisfying the tests of section 165 (a)

(c) Although a plan may provide for termination at will by the employer, this will not of itself prevent a trust from qualifying as exempt under section 165 (a) However, in certain cases that fact may necessitate some provision in the plan which will preclude such termination from effecting the prohibited discriminations. This may occur where, for example, certain officers or highly compensated employees are at the inception of the plan within a few years of retirement age and the operation of the plan will fund and vest their benefits in a short period, thus resulting in such discrimination in favor of such officers or highly compensated employees.

§ 39.165-5 *Period for which requirements of section 165 (a) (3) (4) (5), and (6) are applicable.* A pension, profit-sharing, stock bonus or annuity plan shall be considered as satisfying the requirements of section 165 (a) (3) (4), (5) and (6) for the period beginning with the date on which it was put into effect and ending with the 15th day of the third month following the close of the taxable year of the employer in which the plan was put into effect, if all the provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. Thus, if an employer in 1952 adopts such a plan as of January 1, 1952, and makes a return on the basis of the calendar year, he will have until March 15, 1953, to amend his plan so as to make it satisfy the requirements of section 165 (a) (3) (4), (5) and (6) for the calendar year 1952 provided that by March 15, 1953, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to January 1, 1952, the effective date of the plan. If an employer is on a fiscal year basis, for example, April 1 to March 31, and in 1952 adopts such a plan effective as of April 1, 1952, he will have until June 15, 1953, to amend his plan so as to make it satisfy the requirements of section 165 (a) (3) (4) (5) and (6) for the fiscal year beginning April 1, 1952, and ending March 31, 1953: *Provided,* That by June 15, 1953, all provisions of such plan necessary to satisfy such requirements are in effect and have been

made retroactive for all purposes to April 1, 1952, the effective date of the plan.

§ 39.165-6 *Taxability of beneficiary under a trust which meets the requirements of section 165 (a)*—(a) *In general.* (1) Section 165 (b) (c) and (d) relates to the taxation of the beneficiary of an employees' trust. If an employer makes a contribution for the benefit of an employee to a trust for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust is exempt under section 165 (a) the employee is not required to include such contribution in his income except in the year or years in which such contribution is distributed or made available to him. For rules providing for exclusion from income in the year of distribution of amounts representing unrealized appreciation in the value of securities of the employer corporation, see paragraph (b) of this section. It is immaterial in the case of contributions to an exempt trust whether the employee's rights in the contributions to the trust are forfeitable or nonforfeitable either at the time the contribution is made to the trust or thereafter. The distribution from such an exempt trust when received or made available will be taxable to him as if it were an annuity to the extent provided in section 22 (b) (2) The provisions of section 165 (b) relate only to distributions by a trust which is exempt under section 165 (a) for the taxable year of the trust in which the distribution is made. If a trust is exempt for the taxable year in which the distribution occurs, but was not so exempt for one or more prior taxable years, the amount of any such taxable distribution may be reduced by the part thereof shown to the satisfaction of the Commissioner to be properly allocable to employer's contributions or earnings of the trust previously accounted for as taxable income by the employee or to earnings of the trust previously accounted for as taxable income by the trust. Where the distribution occurs in a taxable year of the trust for which it is not exempt under section 165 (a) the taxability of such distribution will depend on the taxable status of the trust under other provisions of the Internal Revenue Code at the time of the distribution. If such trust was not exempt for one or more prior taxable years, the adjustments outlined above may be made in connection with any distribution.

(2) If a trust exempt under section 165 (a) purchases an annuity contract for an employee and distributes it to the employee in a year for which the trust is exempt, the contract containing a cash surrender value which may be available to an employee by surrendering the contract, such cash surrender value will not be considered income to the employee unless and until the contract is surrendered.

(3) (i) Except as provided in § 39.22 (b) (2)-2, if pension or annuity payments are continued after the death of a retired employee to his beneficiary, such beneficiary will be required to include such pension or annuity payments in income to the same extent that the deceased employee would have been required to include such payments in income had he lived to receive such payments. See also section 126 (a) If the trust purchases under the plan retirement income insurance with life insurance protection payable upon the death of the employee participants, so much of the premiums as was paid from the contributions of the employer or earnings thereon for such life insurance protection will constitute income to the employee for the year or years in which the contributions or earnings are applied to the purchase of such life insurance. If the amount payable upon death at any time during the year exceeds the cash value (or if no cash value, then the reserve) of the insurance policy at the end of the year, the entire amount of such excess will be considered current life insurance protection. The cost of such insurance will be considered to be the 1-year term premium for such amount based upon the rates of the company issuing the annuity contract (or if no 1-year term policy is issued, the cost of such 1-year term computed by using the same mortality table and rate of interest and rate of loading as was used in determining the rates for the annuity contract)

(ii) The determination of the cost of life insurance protection may be illustrated by the following example:

Example. A policy is purchased by an employer for an employee 35 years of age, providing an annuity of $100 per month upon retirement at age 65, with a minimum death benefit of $10,000. The level annual premium for the policy is $436.40. The insurance payable if death occurred in the first year would be $10,000. The cash value at the end of the first year is 0. The net insurance is therefore $10,000 minus 0, or $10,000. Assuming that the 1-year term premium for the same insurance company is $12.15 per $1,000, the premium for $10,000 of life insurance is therefore $121.50, and this is the amount to be reported as income by the employee for the year. The balance of $314.90 is the amount contributed for the annuity, which is not taxable to the employee under a plan meeting the requirements of section 165 (a), except as provided under section 165 (b). Assuming that the cash value at the end of the second year is $480, the net insurance would then be $9,520 for the second year. With a 1-year term rate of $12.33 (age 36), the amount to be reported as income to the employee would be $117.38. Any amounts paid under an annuity contract as a death benefit, not in the nature of life insurance, shall be included in the income of the beneficiary when received, and is not excluded from income under section 22 (b) (1).

(4) If the total distributions payable with respect to any employee under a trust that in the year of distribution is exempt under section 165 (a) are paid to the distributee within one taxable year of the distributee on account of the employee's separation from the service, the amount of such distribution, to the extent it exceeds the amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. For example, if, under a profit-sharing trust, the total distributions to which an employee is entitled are paid, in a taxable year of the trust for which it is exempt, to the employee in the year in which he retires or severs his connection with his employer, or to his widow if he dies during the course of his employment, the amount received by the employee or widow to the extent it exceeds the employee's contributions will be considered a gain from the sale or exchange of a capital asset held for more than six months, to be treated as provided in section 117 (b) See, however, paragraph (b) of this section for rules relating to exclusion from such excess of amounts representing net unrealized appreciation in the value of securities of the employer corporation. As to adjustments if the trust was not exempt for one or more taxable years prior to the year of distribution, see paragraph (a) (1) of this section.

(5) See also § 39.22 (b) (1)-2 as to the limited exclusion from income of death benefits made by or on behalf of an employer in pursuance of an express contract and paid by reason of the death of an employee.

(b) *Distributions including securities of the employer corporation*—(1) *In general.* (i) If a trust exempt under section 165 (a) makes a distribution to a distributee, and such distribution includes securities of the employer corporation, there shall be excluded for purposes of computing the amount of such distribution includible in the distributee's income in the year of distribution net unrealized appreciation in such securities to the following extent:

(*a*) If the distribution constitutes a total distribution to which the rules of paragraph (a) (4) of this section are applicable, the amount to be excluded is the entire net unrealized appreciation attributable to that part of the total distribution which consists of securities of the employer corporation; and

(*b*) If the distribution is other than a total distribution to which paragraph (a) (4) of this section is applicable, the amount to be excluded is that portion of the net unrealized appreciation in the securities of the employer corporation which is attributable to the amount considered to be contributed by the employee to the purchase of such securities.

The amount of net unrealized appreciation which is excludible under the rules of subdivisions (i) and (ii) of this subparagraph shall not be included in the basis of the securities in the hands of the distributee at the time of distribution for purposes of determining gain or loss on subsequent disposition. In the case of a total distribution the amount of net unrealized appreciation which is not included in the basis of the securities in the hands of the distributee at the time of distribution shall be considered to the extent realized in a subsequent taxable transaction as a gain from the sale or exchange of a capital asset held for more than six months. However, if the net gain realized by the distributee exceeds the amount of the net unrealized appreciation, such excess shall constitute a long-term or short-term capital gain de-

pending upon the holding period of the securities in the hands of the distributee.

(ii) For purposes of section 165 (b) and of this section, the term "securities" means only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form, and the term "securities of the employer corporation" includes securities of a parent or subsidiary corporation (as defined in section 130A (d) (2) and (3) relating to employee stock options) of the employer corporation.

(2) *Determination of net unrealized appreciation.* (i) The amount of net unrealized appreciation in securities of the employer corporation which are distributed by the trust is to be determined by reference to the cost or other basis to the trust of such securities and by reference to the market value of such securities at the time of distribution. Thus, if a distribution consists in part of securities which have appreciated in value and in part of securities which have depreciated in value, the net unrealized appreciation shall be considered to consist of the net increase in value of all of the securities included in the distribution. For this purpose, two or more distributions made by a trust to a distributee in a single taxable year of the distributee shall be treated as a single distribution.

(ii) The determination of the cost or other basis to the trust of a distributed security of the employer corporation, for purposes of determining net unrealized appreciation thereon, shall be made in accordance with whichever of the following rules is applicable:

(*a*) If a security was, at the time of purchase by, or contribution to, the trust, earmarked for the account of a particuler employee so that the cost or other basis of such security to the trust is reflected in the account of such employee, such cost or other basis shall be used.

(*b*) If as of the close of each taxable year of the trust (or other specified period of time not in excess of 12 consecutive calendar months) the trust allocates among the accounts of participating employees all securities acquired by the trust during the period (exclusive of securities unallocated under a plan providing for allocation in whole shares only) the cost or other basis to the trust of any securities allocated as of the close of a particular allocation period shall be the average cost or other basis to the trust of all securities of the same type which were purchased or otherwise acquired by the trust during such allocation period. For purposes of determining the average cost to the trust of securities included in a subsequent allocation, the actual cost to the trust of the securities unallocated as of the close of a prior allocation period shall be deemed to be the average cost or other basis to the trust of securities of the same type allocated as of the close of such prior allocation period.

(*c*) In a case where neither (*a*) nor (*b*) is applicable, if the trust fund, or a specified portion thereof, is invested exclusively in one particular type of security of the employer corporation, and if during the period the distributee participated in the plan none of such securities has been sold except for the purpose of paying benefits under the trust or for the purpose of enabling the trustee to obtain funds with which to exercise rights which have accrued to the trust, the cost or other basis to the trust of all securities distributed to such distributee shall be the total amount credited to the account of such distributee (or such portion thereof as was available for investment in such securities) reduced by the amount available for investment but uninvested on the date of distribution. If at the time of distribution to a particular distributee a portion of the amount credited to his account is forfeited, appropriate adjustment shall be made with respect thereto in determining the cost or other basis to the trust of the securities distributed.

(*d*) (*1*) In all other cases, there shall be used the average cost (or other basis) to the trust of all securities of the employer corporation of the type distributed to the distributee which the trust has on hand at the time of the distribution, or which the trust had on hand on a specified inventory date which date does not precede the date of distribution by more than twelve calendar months. If a distribution includes securities of the employer corporation of more than one type, the average cost (or other basis) to the trust of each type of security distributed shall be determined. The average cost to the trust of securities of the employer corporation on hand on a specified inventory date (or on hand at the time of distribution) shall be computed on the basis of their actual cost, considering the securities most recently purchased to be those on hand, or by means of a moving average calculated by subtracting from the total cost of securities on hand immediately preceding a particular sale or distribution an amount computed by multiplying the number of securities sold or distributed by the average cost of all securities on hand preceding such sale or distribution.

(*2*) These methods of computing average cost may be illustrated by the following examples:

Example (*1*). A, a distributee who makes his income tax returns on the basis of a calendar year, receives on August 1, 1952, in a total distribution, to which paragraph (a) (4) of this section is applicable, ten shares of class D stock of the employer corporation. On July 1, 1952 (the specified inventory date of the trust) the trust had on hand 80 shares of class D stock. The average cost of the 10 shares distributed, on the basis of the actual cost method, is $100 computed as follows:

Shares	Purchase date	Cost per share	Total cost
20	June 24, 1952	$101	$2,020
40	Jan. 10, 1951	102	4,080
20	Oct. 20, 1950	95	1,900
80			8,000

Example (2). B, a distributee who makes his income tax returns on the basis of a calendar year, receives on October 30, 1952, in a total distribution, to which paragraph (a) (4) of this section is applicable, 20 shares of class E stock of the employer corporation. The specified inventory date of the trust is the last day of each calendar year. The trust had on hand on December 31, 1950, 1,000 shares of class E stock of the employer corporation. During the calendar year 1951 the trust distributed to four distributees a total of 100 shares of such stock and acquired, through a number of purchases, a total of 120 shares. The average cost of the 20 shares distributed to B, on the basis of the moving average method, is $52 computed as follows:

	Shares	Total cost	Average cost
On hand December 31, 1950	1,000	$50,000	$50
Distributed during 1951 at average cost of $50	100	5,000	
	900	45,000	
Purchased during 1951	120	8,040	
On hand December 31, 1951	1,020	53,040	52

(3) *Unrealized appreciation attributable to employee contributions.* In any case in which it is necessary to determine the amount of net unrealized appreciation in securities of the employer corporation which is attributable to contributions made by an employee:

(i) The cost or other basis of the securities to the trust and the amount of net unrealized appreciation shall first be determined in accordance with the rules in paragraph (b) (2) of this section;

(ii) The amount contributed by the employee to the purchase of the securities shall be solely the portion of his actual contributions to the trust properly allocable to such securities, and shall not include any part of the increment in the trust fund expended in the purchase of the securities;

(iii) The amount of net unrealized appreciation in the securities distributed which is attributable to the contributions of the employee shall be that proportion of the net unrealized appreciation determined under the rules of paragraph (b) (2) of this section which the contributions of the employee properly allocable to such securities bear to the cost or other basis to the trust of the securities;

(iv) If a distribution consists solely of securities of the employer corporation, the contributions of the employee expended in the purchase of such securities shall be allocated to the securities distributed in a manner consistent with the principles set forth in paragraph (b) (2) (ii) (*a*) (*b*), (*c*) or (*d*) of this section, whichever is applicable, that is, the amount of the employee's contribution which can be identified as having been expended in the purchase of a particular security shall be allocated to such security, and the amount of such contribution which cannot be so identified shall be allocated ratably among the securities distributed. If a distribution consists in part of securities of the employer corporation and in part of cash or other property, appropriate allocation of a portion of the employee's contribution to such cash or other property shall be made unless such allocation is inconsistent with the terms of the plan or trust.

(v) The application of this subparagraph may be illustrated by the following example:

Example. A trust distributes ten shares of stock issued by the employer corporation each of which has an average cost to the trust of $100, consisting of employee contributions in the amount of $60 and employer contributions in the amount of $40, and on the date of distribution has a fair market value of $180. The portion of the net unrealized appreciation attributable to the contributions of the employee with respect to each of the shares of stock is $48 computed as follows:

(1) Value of one share of stock on distribution date	$180
(2) Employee contributions	60
(3) Employer contributions	40
(4) Total contributions	100
(5) Net unrealized appreciation	80
(6) Portion of net unrealized appreciation attributable to employee contributions, 60/100 (amount of employee contributions (item 2) over total contributions (item 4) of $80 (item 5)	48

(vi) For the purpose of determining gain or loss to the distributee in the year or years in which any share of stock referred to in the example in subdivision (v) of this subparagraph is sold or otherwise disposed of in a taxable transaction, the basis of each such share in the hands of the distributee at the time of the distribution by the trust will be $132 computed as follows:

(*a*) Employee contributions	$60
(*b*) Employer contributions (taxable as ordinary income in the year the securities were distributed)	40
(*c*) Portion of net unrealized appreciation attributable to employer contributions (item (5) minus item (6)) (taxable as ordinary income in the year the securities were distributed)	32
(*d*) Basis of stock	132

(4) *Change in exempt status of trust.* For principles applicable in making appropriate adjustments if the trust was not exempt for one or more years prior to the year of distribution, see paragraph (a) of this section.

§ 39.165-7 *Treatment of beneficiary of a trust not exempt under section 165 (a)*—(a) *In general.* Generally, any contribution made by an employer on behalf of an employee to a trust during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under section 165 (a) shall be included in income of the employee for his taxable year during which the contribution is made if the employee's beneficial interest in the contribution is nonforfeitable at the time the contribution is made. But see section 165 (d) and paragraph (b) of this section. An employee's beneficial interest in the contribution is nonforfeitable within the meaning of sections 165 (c) and 23 (p) (1) (D) at the time the contribution is made if there is no contingency under the plan which may cause the employee to lose his rights in the contribution. For example, if under the terms of a pension plan, an employee upon termination of his services prior to the retirement date, whether voluntarily or involuntarily, is entitled to a deferred annuity contract to be purchased with the employer's contributions made on his behalf, or is entitled to annuity payments which the trustee is obligated to make under the terms of the trust instrument based on the contributions made by the employer on his behalf, the employee's beneficial interest in such contributions is nonforfeitable. On the other hand, if, under the terms of a pension plan, an employee will lose the right to any annuity purchased from, or to be provided by, contributions made by the employer if his services should be terminated prior to retirement, his beneficial interest in such contributions is forfeitable. The mere fact that an employee may not live to the retirement date, or may live only a short period after the retirement date, and may not be able to enjoy the receipt of annuity or pension payments, does not make his beneficial interest in the contributions made by the employer on his behalf forfeitable. If the employer's contributions have been irrevocably applied to purchase an annuity contract for the employee, or if the trustee is obligated to use the employer's contributions to provide an annuity for the employee provided only that the employee is alive on the dates the annuity payments are due, the employee's rights in the employer's contributions are nonforfeitable.

(b) *Effect of section 165 (d)* (1) If the requirements of section 165 (d) are met, a contribution made by an employer on behalf of an employee to a trust which is not exempt under section 165 (a) shall not be included in the income of the employee in the year in which the contribution is made. Such contribution will be taxable to the employee, when received in later years, as an annuity. (See § 39.22 (b) (2)-5.) The intent and purpose of section 165 (d) is to give those employees, covered under certain nonexempt trusts to which such section applies, essentially the same tax treatment as those covered by trusts qualifying under section 165 (a)

(2) Every person claiming the benefit of section 165 (d) must be able to demonstrate to the satisfaction of the Commissioner that all of the provisions of such section are met. The taxpayer must produce sufficient evidence to prove:

(i) That, prior to October 21, 1942, he was employed by the particular employer making the contribution in question and was at such time definitely covered by a written agreement, entered into before October 21, 1942, between himself and the employer, or between the employer and the trustee of a trust established by the employer prior to October 21, 1942, and that the contribution by the employer was made pursuant to such agreement. The fact that an employee may have been potentially covered is not sufficient. Evidence that the employment was entered into, or the agreement executed, "as of" a date before October 21, 1942, or that the agreement or trust instrument which did not theretofore meet the requirements of section 165 (d) was modified or amended after October 20, 1942, so as to come within the provisions of such section, will not satisfy the requirements of section 165 (d)

(ii) That such contribution, pursuant to the terms of such agreement, was to be applied for the purchase of an annuity contract for the taxpayer. In the case of a contribution by the employer of an annuity contract purchased by such employer and transferred by him to the trustee of the trust, evidence should be presented to prove that such contract was purchased for the taxpayer by the employer pursuant to the terms of a written agreement between the employer and the employee or between the employer and the trustee, entered into before October 21, 1942.

(iii) That under the written terms of the trust agreement the taxpayer is not entitled during his lifetime, except with the consent of the trustee, to any payments other than annuity payments under the annuity contract or contracts purchased by the trustee or by the employer and transferred to the trustee, and that the trustee may grant or withhold such consent free from control by the taxpayer, the employer or any other person (for definition of annuity payments, see § 39.22 (b) (2)-2) However, such control will not be presumed from the fact that the trustee is himself an officer or employee of the employer. As used in section 165 (d) the phrase "if * * * under the terms of the trust agreement the employee is not entitled" means that the trust instrument must make it impossible for the prohibited distribution to occur, whether by operation or natural termination of the trust, whether by power of revocation or amendment, other than with the consent of the trustee, whether by the happening of a contingency by collateral arrangement, or any other means. It is not essential that the employer relinquish all power to modify or terminate the trust but it must be impossible, except with the consent of the trustee, for any payments under annuity contracts purchased by the trustee, or by the employer and transferred to the trustee, to be received by the taxpayer, directly or indirectly, other than as annuity payments.

(iv) The nature and amount of such contribution and the extent to which income taxes have been paid thereon before January 1, 1949, and not credited or refunded.

(v) If it is claimed that section 165 (d) applies to amounts contributed to a trust after June 1, 1949, the taxpayer must prove to the satisfaction of the Commissioner that the trust did not, on June 1, 1949, qualify for exemption under section 165 (a) Where an employer buys an annuity contract which is transferred to the trustee, the date of the purchase of the annuity contract and not the date of the transfer to the trustee is the controlling date in deter-

mining whether or not the contribution was made to the trust after June 1, 1949.

§ 39.166 *Statutory provisions; estates and trusts; revocable trusts.*

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.

§ 39.166-1 *Trusts with power to revest corpus in the grantor*—(a) *Scope.* (1) Where the power to revest in the grantor title to any part of the corpus of a trust is vested in the grantor or in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or both, the income of that part of the corpus subject to the power to revest is not taxable in accordance with the provisions of sections 161, 162, and 163 but remains attributable and taxable to the grantor, except as provided in sections 22 (k) and 171. This section deals with the taxation of such income. As used in this section, the term "corpus" means any part or the whole of the property, real or personal, constituting the subject matter of the trust.

(2) For rules applicable to trusts the income of which is taxable to the grantor under section 22 (a) because the grantor has retained a control of the trust so complete that he is still in practical effect the owner of its income, see § 39.22 (a)-21.

(3) For rules applicable to trusts the income of which is taxable under section 22 (a) to a person other than the grantor because of a power, exercisable solely by such other person, to vest the property or the income therefrom in himself, see § 39.22 (a)-22.

(b) *Test of taxability to grantor.* (1) Section 166 provides for taxability of income to the grantor by reason of the fact that he has retained power to revest the corpus in himself. For the purposes of this section, 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 (except as provided in section 22 (k) or 171) regardless of—

(i) 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;

(ii) 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 specific event;

(iii) 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;

(iv) 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;

(v) When the trust was created.

(2) 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 income from the corpus of a trust is included in the gross income of the grantor under this section because of a power to revest such corpus in the grantor, he shall be allowed those deductions with respect to such corpus as he would have been entitled to had the trust not been created.

§ 39.167 *Statutory provisions; estates and trusts; income for benefit of grantor.*

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 (0), 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."

(c) Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income, in the discretion of another person, the trustee, or the grantor acting as trustee or cotrustee, may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered paid out of income to the extent of the income of the trust for such taxable year which is not paid, credited, or to be distributed under section 162 and which is not otherwise taxable to the grantor.

[Sec. 167 as amended by sec. 134, Rev. Act 1943]

§ 39.167-1 *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 section deals with the taxation of such income. The term "income," as used in this section, means any part or the whole of the income of the trust.

(b) *Test of taxability to the grantor.* (1) The test prescribed by the Internal Revenue Code 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 (except a wife to whom such income is taxable under section 22 (k) or 171) in obedience to his direction or if the income is applied in payment of premiums upon policies of insurance on the grantor's life.

(2) For the purposes of this section, 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 so to 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.

(3) If the grantor has retained any such interest in the income, such income is taxable to the grantor (except as provided in section 22 (k), 167 (c) or 171) regardless of—

(i) Whether it may be distributed currently or accumulated for future distribution;

(ii) Whether such distribution, either current or subject to accumulation, is fixed by the trust instrument or is dependent on an exercise of discretion;

(iii) Whether, if such distribution is in any way affected 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;

(iv) 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;

(v) When the trust was created.

(4) 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 Internal Revenue Code, similarly regarded as remaining in substance the owner of the trust income. See § 39.22 (a)-21.

(5) If the grantor strips himself permanently and definitively 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.

(6) 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.

§ 39.167-2 *Discretionary trusts for maintenance or support of certain beneficiaries.* (a) Section 167 (c) provides that income shall not be taxable to the grantor under section 167 (a) or any other provision of chapter 1 of the Internal Revenue Code merely because such income, in the discretion of another person, the trustee, or the grantor acting as trustee or cotrustee, may be applied or distributed for the support or maintenance of a beneficiary, such as the wife or child of the grantor, whom he is legally obligated to support, except to the extent that such income is actually so applied or distributed. Where income has actually been so applied, such income is taxable to the grantor, whether or not the trust income may also be applied or distributed for purposes other than the maintenance or support of a beneficiary whom the grantor is legally obligated to support.

(b) The grantor of a trust continues to be taxable under section 167 with respect to such income as may, in the discretion of persons lacking a substantial adverse interest, be applied in discharge of his obligations other than his obligation of support or maintenance falling within section 167 (c) Thus, if the grantor creates a trust, the income of which may, in the discretion of a person lacking a substantial adverse interest, be applied in the payment of the grantor's debts, including the payment of his rent or other household expenses, such income is taxable to the grantor regardless of whether it is actually so applied.

(c) Section 167 (c) is not applicable if discretion to apply or distribute the trust income rests solely in the grantor or in the grantor in conjunction with other persons unless the grantor has such discretion as trustee.

(d) Section 167 (c) does not affect the present scope of sections 22 (k) and 171 (relating to alimony and separate maintenance payments taxable to a wife or former wife) Nor does section 167 (c) alter the provisions governing the taxability of trust income to the grantor under some other provision of law, as for example, section 22 (a) See § 39.22 (a)-21.

(e) Section 167 (c) has no application where, under the terms of the trust, income is required to be applied to the support or maintenance of a beneficiary whom the grantor is legally obligated to support.

(f) Section 167 (c) provides that in those cases where amounts applied or distributed for support or maintenance of beneficiaries whom the grantor is legally obligated to support are paid out of corpus or out of other than income for the taxable year such amounts are to be considered paid out of income to the extent of the income of the trust for such taxable year which is not paid, credited, or to be distributed under section 162 and which is not otherwise taxable to the grantor. For example, a trust indenture provides for the annual payment of income, not exceeding $7,000, to the grantor's adult son whom he is not legally obligated to support; for the payment of premiums on policies of insurance on the life of the grantor in an amount not to exceed $3,000 per annum; and for the application, in the trustee's discretion, of any part of the remaining income or of corpus for the support of the grantor's minor daughter. The entire income for the taxable year is $12,000. The trustee pays $7,000 of such income to the son and $3,000 thereof for insurance premiums, and $6,000 is applied for the support of the minor daughter. The grantor is taxable under section 167 (c) with respect to $2,000 of the sum applied to the support of the daughter, whether paid out of income or out of principal ($12,000 less $7,000 paid, credited or distributed under section 162, and less $3,000 taxable to the grantor under section 167 (a) (3))

§ 39.168-169 *Statutory provisions; estates and trusts; taxes of foreign countries and possessions of United States; common trust funds.*

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 chapter, subchapter A or B of chapter 2, or section 105 or 106 of the Revenue Act of 1935, 49 Stat. 1017, 1019, or chapter 6 and for the purposes of such chapters and subchapters 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 part of its gains and losses from sales or exchanges of capital assets held for not more than 6 months, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for not more than 6 months.

(B) As part of its gains and losses from sales or exchanges of capital assets held for more than 6 months, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for more than 6 months.

(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. If the common trust fund elects under section 125 to treat the premium on bonds, the interest on which is allowable as a credit under section 25 (a) (1) or (2), as amortizable, for the purposes of the preceding sentence the proportionate share of the participant of such interest received by the common trust fund shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 23 (v) as is attributable to such share.

(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 gains and losses from sales or exchanges of capital assets;

(2) After excluding all items of gain and loss from sales or exchanges of capital assets, there shall be computed—

(A) An ordinary net income which shall consist of the excess of the gross income over 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.

(4) The standard deduction provided in section 23 (aa) 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 chapter, 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.* 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, 1939) ending within or with the taxable year of the participant.

[Sec. 169 as amended by secs. 126 (e), 150 (f), Rev. Act 1942; sec. 9 (b) (2), Individual Income Tax Act 1944]

§ 39.169–1 *Common trust fund defined.* (a) 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—

(1) 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· (i) As a trustee of a trust created by will, deed, agreement, declaration of trust, or order of court, (ii) as an executor of the will of, or as an administrator of the estate of, a deceased person, or (iii) 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

(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, whether or not the bank maintaining such fund is a national bank or a member of the Federal Reserve System.

(b) Except as otherwise provided in this section and §§ 39.169–2 to 39.169–5, inclusive, the term "participant" refers to any trust or estate, the moneys of, which have been contributed to the common trust fund.

§ 39.169–2 *Income of participants in common trust fund.* (a) Each participant in a common trust fund 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 gains and losses from sales or exchanges of capital assets held for not more than six months, computed as provided in § 39.169–3, as part of its gains and losses from sales or exchanges of capital assets held for not more than six months.

(2) Its proportionate share of the gains and losses from sales or exchanges of capital assets held for more than six months, computed as provided in § 39.169–3, as part of its gains and losses from sales or exchanges of capital assets held for more than six months.

(3) Its proportionate share of the ordinary net income or the ordinary net loss of the common trust fund, computed as provided in § 39.169–3.

(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 reduction of credit for such interest on account of amortizable bond premium, see § 39.125 (c)–2.) For the purposes of the Internal Revenue Code, 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) (1) The proportionate share of each participant in the gains and losses from sales or exchanges of capital assets held for not more than six months, gains and losses from sales or exchanges of capital assets held for more than six months, 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.

(2) 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, gains and losses from sales or exchanges of capital assets held for not more than six months, and gains and losses from sales or exchanges of capital assets held for more than six months computed for each such period. The proportionate shares of the participants in such items are then to be determined.

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

Example. (i) 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, the short-term capital gain, and the long-term capital loss 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
Short-term capital gain	200	100	200	100	600
Long-term capital loss	100	200	100	200	600

(ii) 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

(iii) The participants' shares of the short-term capital gain are as follows:

PARTICIPANTS' SHARES OF SHORT-TERM CAPITAL GAIN

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$25	$50	$25	$150
B	50	25	50	25	150
C	50	25			75
D	50				50
E		25			25
F			50	25	75
G			50	25	75
Total	200	100	200	100	600

(iv) The participants' shares of the long-term capital loss are as follows:

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$25	$50	$25	$50	$150
B	25	50	25	50	150
C	25	50			75
D	25				25
E		50			50
F			25	50	75
G			25	50	75
Total	100	200	100	200	600

(4) If in the above example the common trust fund also had short-term capital losses and long-term capital gains, the treatment of such gains or losses would be similar to that accorded to the short-term capital gains and long-term capital losses in the above example.

(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.

§ 39.169–3 *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:

(a) No deduction shall be allowed under section 23 (o) for charitable contributions.

(b) The gains and losses from sales or exchanges of capital assets of the common trust fund are required to be segregated. A common trust fund is not allowed the benefit of the capital loss carry-over provided by section 117 (e)

(c) 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 gains and losses from sales or exchanges of capital-assets.

(d) The standard deduction provided in section 23 (aa) shall not be allowed.

§ 39.169-4 *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, as amended, for the benefit of all the then participants in the common trust fund. Such segregated investment 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 section and minus the reductions prescribed in paragraph (d) of this section. 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, as amended. 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 section, 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 after December 31, 1937,

(4) The excess of the gains over the losses recognized to the common trust fund for each taxable year beginning after December 31, 1937, upon sales or exchanges of capital assets held for more than 18 months (more than 6 months for taxable years beginning after December 31, 1941) and

(5) Ordinary net income of the common trust fund for each taxable year beginning after December 31, 1937.

(d) *Reductions in basis.* As prescribed in paragraph (b) of this section, 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 before 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 after December 31, 1937.

§ 39.169-5 *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 chapter 1, and shall include each participant's name and address, the ordinary net income or loss, and its proportionate share of gains and losses from sales or exchanges of capital assets. See § 39.169-2. 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 verified in the same manner as the return filed by the bank under section 52.

§ 39.170 *Statutory provisions; estates and trusts; net operating losses.*

SEC. 170. *Net operating losses.* The benefit of the deduction for net operating losses allowed by section 23 (s) shall be allowed to estates and trusts under regulations prescribed by the Commissioner with the approval of the Secretary. The benefit of such deduction shall not be allowed to a common trust fund, but shall be allowed to the participants in the common trust fund under regulations prescribed by the Commissioner with the approval of the Secretary.

[Sec. 170 as added by sec. 211 (c), Rev. Act 1939]

§ 39.170-1 *Net operating loss deduction in the case of estates, trusts, and common trust funds*—(a) *Estates and trusts.* The net operating loss deduction allowed by section 23 (s), computed as provided by section 122, shall be available to estates and trusts generally, with the following exceptions and limitations:

(1) A net operating loss for a year for which a trust was exempt from tax under section 165 may not be used in the computation of the net operating loss carry-over.

(2) In computing gross income and deductions for the purposes of section 122, a trust shall exclude that portion of the income and deductions attributable to the grantor under section 166 and § 39.166-1 (c)

(3) An estate or trust shall not, for the purposes of section 122, avail itself of the deductions allowed by section 162.

(b) *Common trust funds.* The net operating loss deduction is not allowed to a common trust fund. Each participant in a common trust fund, however, will be allowed the benefits of such deduction. In the computation of such deduction a participant in a common trust fund shall take into account its pro rata share of the income and losses of the common trust fund as prescribed by § 39.189-1 in the case of partners.

§ 39.171 *Statutory provisions; estates and trusts; income in divorce, etc., cases.*

SEC. 171. *Income of an estate or trust in case of divorce, etc.*— (a) *Inclusion in gross income.* There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance the amount of the income of any trust which such wife is entitled to receive and which, except for the provisions of this section, would be includible in the gross income of her husband, and such amount shall not, despite section 166, section 167, or any other provision of this chapter, be includible in the gross income of such husband. This subsection shall not apply to that part of any such income of the trust which the terms of the decree or trust instrument fix, in terms of an amount of money or a portion of such income, as a sum which is payable for the support of minor children of such husband. In case such income is less than the amount specified in the decree or instrument, for the purpose of applying the preceding sentence, such income, to the extent of such sum payable for such support, shall be considered a payment for such support.

(b) *Wife considered a beneficiary.* For the purposes of computing the net income of the estate or trust and the net income of the wife described in section 22 (k) or subsection (a) of this section, such wife shall be considered as the beneficiary specified in this supplement. A periodic payment under section 22 (k) to any part of which the provisions of this supplement are applicable shall be included in the gross income of the beneficiary in the taxable year in which under this supplement such part is required to be included.

[Sec. 171 as added by sec. 120 (c), Rev. Act 1942]

§ 39.171-1 *Income of trust in case of divorce, etc.*—(a) *In general.* (1) Section 171 (a) provides rules in certain cases for taxability of income of trusts as between spouses who are divorced or legally separated under a court order or decree. In such cases, the spouse actually entitled to receive payments from the trust is considered the beneficiary rather than the spouse in discharge of whose obligation such payments are made. For convenience, the beneficiary spouse will hereafter in this section and in § 39.171-2 be referred to as the "wife" and the obligor spouse from whom she is divorced or legally separated as the "husband." (See section 3797 (a) (17).) Thus, under section 171 (a) income of a trust—

(i) Which is paid, credited or to be distributed to the wife in a taxable year of the wife, and

(ii) Which, except for the provisions of section 171, would be includible in the gross income of her husband,

shall be includible in her gross income and shall not be includible in his gross income.

(2) Section 171 (a) does not apply in any case to which section 22 (k) applies. Although section 171 (a) and section 22 (k) seemingly cover some of the same situations, there are important differences between them. Thus, section 171 (a) applies, for example, to a trust created before the divorce or separation and not in contemplation of it, while section 22 (k) applies only if the creation of the trust or payments by a previously created trust are in discharge of a legal obligation imposed upon or assumed by the husband (or made specific) under the court decree or an instrument incident to the divorce or legal separation. On the other hand, section 22 (k) requires inclusion in the wife's income of the full amount of periodic payments received attributable to property in trust (whether or not out of trust income), while section 171 (a) requires amounts paid, credited or to be distributed to her to be included only to the extent such amounts are out of income of the trust for its taxable year (determined as provided in section 162).

(3) Section 171 (a) is designed to produce uniformity as between cases described in section 171 (a) and cases not described in section 171 (a) where, in the former cases, without section 171 (a), the income of a so-called alimony trust would be taxable to the husband because of his continuing obligation to support his former wife, and where, in the latter cases, the income of a so-called alimony trust is taxable to the former wife because of the termination of the husband's obligation. Furthermore, section 171 (a) taxes trust income to the wife in all cases where under prior law the husband would be taxed not only because of the discharge of his alimony obligation but also because of his retention of control over the income or trust corpus. Section 171 (a) applies whether or not the wife is the beneficiary under the terms of the trust instrument or is an assignee of a beneficiary.

(4) The application of section 171 (a) may be illustrated by the following examples, in which it is assumed that both the husband and wife make their income tax returns on a calendar year basis:

Example (1). Upon the marriage of H and W, H irrevocably transfers property in trust to pay the income therefrom to W for her life for support, maintenance, and all other expenses. Some years later, W obtains a legal separation from H under an order of court. W, relying upon the income from the trust payable to her, does not ask for any provision for her support and none is ordered by the court; the court, however, has jurisdiction under the law of the State to order at any time prior to an absolute divorce that provision be made by H for W's support. Under the provisions of section 171 (a), the income of the trust which becomes payable to W after the order of separation is includible in her income and is deductible by the trust. No part thereof is includible in H's income or deductible by him.

Example (2). H transfers property in trust for the benefit of W, retaining the power to revoke the trust at any time. H, however, promises that if he revokes the trust he will transfer to W property in the value of $100,000. The transfer in trust and the agreement were not incident to divorce, but some years later W divorces H. The court decree is silent as to alimony and the trust. After the divorce, income of the trust which becomes payable to W is taxable to her, and is not taxable to H or deductible by him. If H later terminates the trust and transfers $100,000 of property to W, such $100,000 is not income to W nor deductible by H.

(b) *Alimony trust income designated for support of minor children.* Section 171 (a) does not require the inclusion in the wife's income of trust income which the terms of the decree or trust instrument fix in terms of an amount of money or a portion of such income as a sum which is payable for the support of minor children of the husband. The statute prescribes the treatment in cases where under the terms of the decree or trust instrument a specific amount of trust income is to be paid but a lesser amount becomes payable. In such cases, to the extent of the sum which would be payable for such support out of the originally specified amount of trust income, such trust income is considered payable for support of such minor children. This rule is similar to that provided in the case of periodic payments under section 22 (k). See § 39.22 (k)-1 (d).

§ 39.171-2 *Application of trust rules to alimony payments.* (a) For the purpose of the application of sections 162, 163, and 164, the wife described in section 171 or section 22 (k) who is entitled to receive payments attributable to property in trust is considered a beneficiary of the trust, whether or not the payments are made for the benefit of the husband in discharge of his obligations.

(b) A periodic payment includible in the wife's gross income under section 22 (k) attributable to property in trust shall be included in full in her gross income in her taxable year in which any part is required to be included under sections 162 and 164. Assume, for example, in a case in which both the wife and the trust file income tax returns on the calendar year basis, that an annuity of $5,000 is to be paid to the wife by the trustee every December 31, (out of trust income if possible and, if not, out of corpus) pursuant to the terms of a divorce decree. Of the $5,000 distributable on December 31, 1952, $4,000 is payable out of income and $1,000 out of corpus. The actual distribution is made in 1953. Although the periodic payment is received by the wife in 1953, since under sections 162 and 164 the $4,000 income distributable on December 31, 1952, is to be included in the wife's income for 1952, the $1,000 payment out of corpus is to be included in her income for 1952.

§ 39.172 *Statutory provisions; estates and trusts; allowance of amortization deduction.*

SEC. 172. *Allowance of amortization deduction.* The benefit of the deduction for amortization of emergency facilities allowed by section 23 (t) shall be allowed to estates and trusts in the same manner and to the same extent as in the case of an individual. The allowable deduction shall be apportioned between the income beneficiaries and the fiduciary under regulations prescribed by the Commissioner with the approval of the Secretary.

[Sec. 172 as added by sec. 155 (g), Rev. Act 1942]

§ 39.172-1 *Amortization of emergency facility of estate or trusts.* In the case of an emergency facility, as defined in section 124A (d) acquired or completed by an estate or trust after December 31, 1949, such estate or trust is entitled to take amortization deductions with respect thereto in the same manner and to

the same extent as in the case of an individual. See section 23 (t) and section 124A and the regulations thereunder. The principles governing the apportionment of depreciation in the case of property held in trust are applicable with respect to the amortization of an emergency facility of an estate or trust. See § 39.23 (l)-1.

SUPPLEMENT F—PARTNERSHIPS

§ 39.181 *Statutory provisions; partnerships; liability for tax.*

SEC. 181. *Partnership not taxable.* Individuals carrying on business in partnerships shall be liable for income tax only in their individual capacity.

§ 39.181-1 *Partnerships.* Partnerships as such are not subject to the income tax imposed by chapter 1, but are required to make returns of income. See sections 187 and 188. For definition of what the term "partnership" includes, see section 3797 (a) (2) For rules as to allocation of partnership income in the case of family partnerships, see section 191 and the regulations thereunder.

§ 39.182 *Statutory provisions; partnerships; tax of partners.*

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 part of his gains and losses from sales or exchanges of capital assets held for not more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than 6 months.

(b) As part of his gains and losses from sales or exchanges of capital assets held for more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than 6 months.

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

[Sec. 182 as amended by sec. 150 (g) (1), Rev. Act 1942]

§ 39.182-1 *Distributive shares of partners.* (a) 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 part of his gains and losses from sales or exchanges of capital assets held for not more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than six months.

(2) As part of his gains and losses from sales or exchanges of capital assets held for more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than six months.

(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 separate returns are made by a 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 gains and losses of the partnership from sales or exchanges of capital assets or the part of his distributive share of 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.

§ 39.183 *Statutory provisions; partnerships; computation of income.*

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), (c), and (d).

(b) *Segregation of items*—(1) *Capital gains and losses.* There shall be segregated gains and losses from sales or exchanges of capital assets.

(2) *Ordinary net income or loss.* After excluding all items of gain and loss from sales or exchanges of capital assets, 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.

(d) *Standard deduction.* In computing the net income of the partnership, the standard deduction provided in section 23 (aa) shall not be allowed.

[Sec. 183 as amended by sec. 150 (g) (2), Rev. Act 1942; sec. 9 (c), Individual Income Tax Act 1944]

§ 39.183-1 *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:

(a) The partnership is required to segregate its gains and losses from sales or exchanges of capital assets. A partnership is not allowed the benefit of section 117 (e)

(b) The partnership is further required, after excluding all items described in paragraph (a) of this section, to compute (1) an ordinary net income which consists of the excess of gross income over the deductions, or (2) 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.

(c) The partnership is not allowed the standard deduction provided in section 23 (aa)

§ 39.184 *Statutory provisions; partnerships; credits against net income.*

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. If the partnership elects under section 125 to treat the premium on bonds, the interest on which is allowable as a credit under section 25 (a) (1) or (2), as amortizable, for the purposes of the preceding sentence the partner's proportionate share of the interest received by the partnership shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 23 (v) as is attributable to such share.

[Sec. 184 as amended by sec. 126 (f), Rev. Act 1942]

§ 39.184-1 *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. For reduction of credit for such interest on account of amortizable bond premium, see § 39.125 (c)-2.

§ 39.185-187 *Statutory provisions; partnerships; earned income; taxes of foreign countries and possessions of the United States; returns.*

SEC. 185. *Earned income.*
[Repealed by sec. 107 (a), Rev. Act 1943]

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 chapter and such other information for the purpose of carrying out the provisions of this chapter 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 re-

turn shall be sworn to by any one of the partners.

§ 39.187-1 *Partnership returns.* Every partnership shall make a return of income, regardless of the amount of its net income (see section 3797 (a) (2) 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 contain or be verified by a written declaration, signed by one of the partners, that it is made under the penalties of perjury. 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, except that the return shall not be placed on an annual basis under section 47 (c)

§ 39.188-189 *Statutory provisions; partnership; different taxable years of partner and partnership; net operating losses.*

SEC. 188. *Different taxable years of partner and partnership.* 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, 1939) ending within or with the taxable year of the partner.

SEC. 189. *Net operating losses.* The benefit of the deduction for net operating losses allowed by section 23 (s) shall not be allowed to a partnership but shall be allowed to the members of the partnership under regulations prescribed by the Commissioner with the approval of the Secretary.

[Sec. 189 as added by sec. 211 (d), Rev. Act 1939]

§ 39.189-1 *Net operating loss deduction in the case of partners*—(a) *In general.* The benefit of the deduction for net operating losses provided by section 23 (s) shall not be allowed to a partnership. In computing his own net operating loss or his own net income (where required to be computed in accordance with the exceptions and limitations provided in section 122 (d) (1) to (4) inclusive) for any taxable year for the purposes of the computations required by section 122, however, each partner shall take into account the income and losses of the partnership in accordance with sections 182 to 188, inclusive, with the exceptions and limitations set forth in paragraphs (b) and (c) of this section.

(b) *Exceptions and limitations applicable in computation of partner's net operating loss*—(1) *Long-term capital gains and losses.* The partnership's gains and losses from sales or exchanges of capital assets held for more than six months shall be taken into account in full. The business gains and losses from sales or exchanges of capital assets held for more than six months and the nonbusiness gains and losses from such sales or exchanges shall be segregated and his distributive share of the partnership's business gains and losses from such sales or exchanges and the partnership's nonbusiness gains and losses from such sales or exchanges shall be included by each partner as business and nonbusiness gains and losses from the sales or exchanges of capital assets held for more than six months, respectively.

(2) *Short-term capital gains and losses.* The partnership's business gains and losses from sales or exchanges of capital assets held for not more than six months and the partnership's nonbusiness gains and losses from such sales or exchanges shall be segregated, and his distributive share of such business gains and losses and such nonbusiness gains and losses shall be included by each partner as business and nonbusiness gains or losses from sales or exchanges of capital assets held for not more than six months, respectively.

(3) *Ordinary net income or loss.* (i) After excluding all items required to be segregated by subparagraphs (1) and (2) of this paragraph, there shall be computed—

(*a*) A business ordinary net income of the partnership, which shall consist of the excess of the business gross income over the business deductions; or

(*b*) A business ordinary net loss of the partnership, which shall consist of the excess of the business deductions over the business gross income; and

(*c*) A nonbusiness ordinary net income of the partnership, which shall consist of the excess of the nonbusiness gross income over the nonbusiness deductions; or

(*d*) A nonbusiness ordinary net loss of the partnership, which shall consist of the excess of the nonbusiness deductions over the nonbusiness gross income.

In making the above computations the limitations and exceptions provided by section 122 (d) (1) and (2) shall be applied.

(ii) His distributive share of a business ordinary net income of the partnership shall be included by each partner as ordinary business gross income, and of a business ordinary net loss of the partnership as an ordinary business deduction. His distributive share of a nonbusiness ordinary net income of the partnership shall be included by each partner as ordinary nonbusiness gross income, and of a nonbusiness ordinary net loss of the partnership as an ordinary nonbusiness deduction.

(c) *Exceptions and limitations applicable in computation of partner's net income.* (1) The ordinary net income or ordinary net loss of the partnership shall be computed with the exceptions and limitations provided in section 122 (d) (1) and (2)

(2) The partnership's gains and losses from sales or exchanges of capital assets held for more than six months shall be taken in account in full.

§ 39.190 *Statutory provisions; partnerships; allowance of amortization deduction.*

SEC. 190. *Allowance of amortization deduction.* In the case of emergency facilities of a partnership, the benefit of the deduction for amortization allowed by section 23 (t) shall not be allowed to the members of a partnership but shall be allowed to the partnership in the same manner and to the same extent as in the case of an individual.

[Sec. 190 as added by sec. 155 (b), Rev. Act 1942]

§ 39.190-1 *Amortization of emergency facility of partnership.* In the case of an emergency facility, as defined in section 124A (d) (1) acquired or completed by a partnership after December 31, 1949, the partnership is entitled to take amortization deductions with respect thereto in the same manner and to the same extent as in the case of an individual. See section 23 (t) and section 124A and the regulations thereunder. Amortization deductions with respect to an emergency facility of a partnership are not allowed to the members of the partnership.

§ 39.191 *Statutory provisions; partnerships; family partnerships.*

SEC. 191. *Family partnerships.* In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service. For the purpose of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons.

[Sec. 191 as added by sec. 340 (b), Rev. Act 1951]

§ 39.191-1 *Family partnerships*—(a) *In general*—(1) *Introduction.* The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. The provisions of Supplement F, which govern the taxation of the income of individuals carrying on business in partnership, are to be read in the light of their relationship to section 22 (a) which requires that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.

(2) *Recognition of donee as partner* With respect to partnerships in which capital is a material income-producing factor, section 3797 (a) (2) (dealing with definition of partnership and partner) provides that a person shall be recognized as a partner for income tax purposes if he owns a capital interest in such a partnership whether or not such

interest is derived by purchase or gift from any other person. In the case of any partnership in which capital is a material income-producing factor, if any capital interest in such partnership is created by gift, section 191 provides for allocation of the partnership income where the distributive share of a donee partner under the partnership agreement is determined without allowance of reasonable compensation for services rendered to the partnership by the donor or is proportionately greater than the share of the donor attributable to the donor's capital. For rules of allocation, see § 39.191-2.

(3) *Requirement of complete transfer to donee.* A donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 3797 (a) (2) unless the capital interest is acquired in a bona fide transaction, not a mere sham for tax avoidance purposes or otherwise, and the donee or purchaser is the real owner of such interest. To be recognized, a transfer must vest dominion and control of the partnership interest in the transferee. The existence of such dominion and control in the donee is to be determined from all the pertinent facts and circumstances. A transfer is not recognized if the transferor retains such incidents of ownership that the transferee has not acquired full and complete ownership of the partnership interest. Transactions between members of a family will be closely scrutinized, and in the case of such transactions the circumstances at the time of a purported transfer and during the periods preceding and following it will be taken into consideration in determining the bona fides or lack of bona fides of the purported gift or sale. A partnership may be recognized for income tax purposes as to some alleged partners but not as to others.

(4) *Capital as a material income-producing factor* The determination as to whether capital is a material income-producing factor, for purposes of section 3797 (a) (2) must be made by reference to all the relevant facts of the individual case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or equipment.

(5) *Capital interest in a partnership.* For purposes of sections 191 and 3797 (a) (2) a capital interest in a partnership means an interest in the capital of the partnership, including accretions thereto, which interest is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon dissolution or liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

(b) *Basic tests as to ownership*—(1) *In general.* Whether an alleged partner in a gift capital case is the real owner of the capital interest attributed to him and whether the donee has dominion and control over his or her interest, must be ascertained from all the facts and circumstances of the particular case. Isolated facts should not be considered determinative; the reality of the donee's ownership is to be determined in the light of the transaction as a whole. The execution of legally sufficient and irrevocable deeds or other instruments of gift under State law is a factor to be taken into account but is not determinative of ownership in the donee. The reality of the transfer and of the donee's ownership of the property attributed to him are to be ascertained from the conduct of the parties with respect to the alleged gift and not by any mechanical or formulistic test. Some of the more important factors to be considered in determining whether the donee has acquired ownership of the capital interest in a partnership are indicated in subparagraphs (2) to (10) inclusive, of this paragraph.

(2) *Retained controls.* The donor may have retained such controls of the interest which he has purported to transfer to the donee that the donor should be treated as remaining the substantial owner of the interest. Controls of particular significance include, for example, the following:

(i) Retention of control of the distribution of income or restrictions on the distribution of income other than amounts retained in the partnership annually with the consent of the partners (including the donee partner) for the reasonable needs of the business. If there is a partnership agreement providing for a managing partner, or partners, then, amounts of income may be retained in the partnership without the acquiesence of all the partners if such amounts are retained for the reasonable needs of the business.

(ii) Limitation of the right of the donee to withdraw or sell his interest in the partnership at his discretion without financial detriment.

(iii) Retention of control of assets essential to the business (for example, through retention of assets leased to the alleged partnership)

(iv) Retention of management powers inconsistent with normal relationships among partners. Retention by the donor of control of business management or of voting control, such as is common in ordinary business relationships, is not by itself to be considered as inconsistent with normal relationships among partners provided the donee is free to withdraw his interest without financial detriment at his discretion. The donee shall not be considered free to withdraw his interest unless, considering all the facts, it is evident that the donee is independent of the donor and has such maturity and understanding of his rights as to be capable of deciding to exercise, and of exercising, his right to withdraw his capital interest from the partnership.

The existence of some of the indicated controls, though amounting to less than substantial ownership retained by the donor, may be considered along with other facts and circumstances as tending to show the lack of reality of the partnership interest of the donee.

(3) *Indirect controls.* Controls inconsistent with ownership by the donee may be exercised indirectly as well as directly for example, through a separate business organization, estate, trust, individual, or other partnership. Where such indirect controls exist, the reality of the donee's interest will be determined as if such controls were exercisable directly.

(4) *Participation in management.* Substantial participation by the donee in the control and management of the business (including participation in the major policy decisions affecting the business) is strong evidence of a donee partner's exercise of the dominion and control over his interest. Such participation presupposes sufficient maturity and experience on the part of the donee to deal with the business problems of the partnership.

(5) *Income distributions.* The actual distribution to a donee partner of all or the major portion of his distributive share of the business income for the sole benefit and use of the donee is substantial evidence of the reality of the donee's interest provided the donor has not retained controls inconsistent with real ownership in the donee. Amounts distributed are not considered to be used for the donee's sole benefit if, for example, they are deposited, loaned, or invested in such ways that the donor controls or can control the use or enjoyment of such funds.

(6) *Conduct of partnership business.* In determining the reality of the donee's ownership of a capital interest in a partnership, consideration shall be given to whether the donee is actually treated as a partner in the operation of the business. It is of principal importance for this purpose whether the donee has been held out publicly as a partner in the conduct of the business, in relations with customers, or with creditors or other sources of financing. Other factors of significance in this connection include:

(i) Compliance with local partnership, fictitious name, and business registration statutes.

(ii) Control of business bank accounts.

(iii) Recognition of the donee's interest in appropriate capital and drawing accounts.

(iv) Recognition of the donee's interest in insurance policies, leases, and other business contracts and in litigation affecting business.

(v) The existence of written agreements, records or memoranda, contemporaneous with the taxable year or years concerned, establishing the nature of the partnership agreement and the

rights and liabilities of the respective partners.

(vi) Filing of partnership tax returns as required by law.

However, despite formal compliance with the above factors, other circumstances may indicate that the donor has retained substantial ownership of the interest purportedly transferred to the donee.

(7) *Trustees as partners.* A trustee may be recognized as a partner for income tax purposes under the principles relative to family partnerships generally as applied to the particular facts of the trust-partnership arrangement. A trustee who is unrelated to and independent of the grantor, and who participates as a partner and receives distribution of the income distributable to the trust, will ordinarily be recognized as the owner of the partnership interest which he holds for the trust unless the grantor has retained controls inconsistent with such ownership. However, if the grantor is the trustee, or if the trustee is amenable to the will of the grantor, the provisions of the trust instrument (particularly with relation to whether the trustee is subject to the responsibilities of a fiduciary) the provisions of the partnership agreement, and the conduct of the parties must all be taken into account in determining whether the trustee in a fiduciary capacity has become the real owner of the partnership interest. In a case where the grantor (or person amenable to his will) is the trustee, the trust may be recognized as a partner only if the grantor (or such other person) in his participation in the affairs of the partnership actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary, and does not subordinate such interests to the interests of the grantor. Furthermore, if the grantor (or person amenable to his will) is the trustee, particular consideration should be given to the following factors:

(i) Whether the trust is recognized as a partner in business dealings with customers and creditors, and

(ii) Whether, if the partnership income is not properly retained for the reasonable needs of the business, the trust's share of the income is distributed to the trust annually and paid to the beneficiaries or reinvested solely in the interests of the beneficiaries.

(8) *Interests of minor children (not held in trust)* Except where a minor child is shown to be competent to manage his own property and participate in the partnership activities in accordance with his interest in the property, a minor child generally will not be recognized as a member of a partnership unless control of the property and its enjoyment is exercised by another person as fiduciary for the sole benefit of the child and unless there is such judicial supervision of the conduct of the fiduciary, guardian or otherwise, as is required by law. The use of the child's property or income for support for which a parent is legally responsible will be considered a use for the parent's benefit. "Judicial supervision of the conduct of a fiduciary" includes filing of such accountings and reports as are required by law of the fiduciary who participates in the affairs of the partnership on behalf of the minor. A minor child will be considered as competent to manage his own property if he actually has sufficient maturity and experience to be treated by disinterested persons as competent to enter business dealings and otherwise to conduct his affairs on a basis of equality with adult persons, notwithstanding legal disabilities of the minor under State law.

(9) *Donees as limited partners.* The recognition of a donee's interest in a limited partnership will depend, as in the case of other donated interests, on whether the transfer of property is real and the donee has acquired dominion and control over the interests purportedly transferred to him. To be recognized for Federal income tax purposes, a limited partnership must be organized and conducted in accordance with the requirements of the applicable State limited partnership law. The absence of services and participation in management by a donee in a limited partnership is immaterial if the limited partnership meets all the other requirements prescribed in this section. If the limited partner's right to withdraw his interest is subject to substantial restrictions (for example, where the interest of the limited partner is not assignable in a real sense or where it may be required to be left in the business for a long term of years), or if the general partner retains any other control which substantially limits any of the rights which would ordinarily be exercisable by unrelated limited partners in normal business relationships, such restrictions on the right to withdraw or retention of other control will be considered strong evidence of lack of reality of ownership by the donee.

(10) *Motive.* If the reality of the transfer of interest is satisfactorily established, the motives for the transaction are immaterial. However, the presence or absence of a tax avoidance motive is one of many factors to be considered in determining the reality of a gift capital transaction.

(c) *Purchased interest*—(1) *In general.* If a purported purchase of a capital interest in a partnership does not meet the requirements of subparagraph (2) of this paragraph, the ownership by the transferee of such capital interest will be recognized only if it qualifies under the requirements applicable to a transfer of a partnership interest by gift. In a case not qualifying under subparagraph (2), if payment of any part of the purchase price is made out of the partnership earnings, the transaction may be regarded in the same light as a purported gift subject to deferred enjoyment of the income. Such a transaction may be lacking in reality either as a gift or as a bona fide purchase.

(2) *Tests as to reality of purchased interests.* A purchase of a capital interest in a partnership either directly or by means of a loan or credit extended by a member of the family will be recognized if it is shown to be bona fide under either of the following tests:

(i) That the purchase has the usual characteristics of an arm's length transaction, considering all relevant factors including the terms of the purchase agreement (as to price, due date of payment, rate of interest, and security, if any) and the terms of any loan or credit arrangement collateral to the purchase agreement; the credit standing of the purchaser, apart from relationship to the seller; and the capacity of the purchaser to incur a legally binding obligation; or

(ii) Assuming the lack of one or more of the usual characteristics of arm's length dealing, that the transaction was genuinely intended to promote the success of the business through securing participation in the business of the purchaser or the addition of his or her credit to that of other participants.

However, if the alleged purchase price or loan has not been paid or the obligation otherwise discharged the factors indicated in subdivisions (i) and (ii) of this subparagraph, shall be taken into account only as an aid in determining whether a bona fide purchase or loan obligation existed.

§ 39.191-2 *Allocation of family partnership income*—(a) *In general.* (1) In the case of any partnership in which capital is a material income-producing factor, if any capital interest in such a partnership is created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share attributable to the donor's capital. For the purpose of this section, a capital interest in a partnership purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. For the purpose of the preceding sentence, the "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons.

(2) To the extent that the partnership agreement does not so allocate the partnership income, the partnership income of the donor and donee shall be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of such income (other than a reasonable allowance for the services, if any, rendered by the donee) to the partnership capital of the donor and donee. The portion of income, if any, thus attributable to partnership capital for the taxable year shall be allocated between donor and donee in accordance with their respective interests in the partnership capital.

(3) In determining a reasonable allowance for services rendered by the partners, consideration shall be given to all the circumstances of the business, including the fact that some of the partners may have greater managerial responsibility than others. Among other factors, there shall be considered the amount that would ordinarily be paid in order to obtain comparable services from a person not having a capital interest in the partnership.

(4) In the case of a partner who rendered services to a partnership before entering service in the armed forces of the United States, his distributive share in the earnings of the partnership, determined under subparagraph (2) of this paragraph, shall not be diminished because of absence due to military service. Such distributive share shall be adjusted to reflect increases or decreases in the capital interest of the absent partner. However, the partners may by agreement allocate a smaller share to the absent partner due to his absence.

(b) *Special rules.* (1) The provisions of paragraph (a) of this section, relating to allocation, are applicable where the gift interest in the partnership is created indirectly as well as directly. Where the partnership interest is created indirectly, the term "donor" may include persons other than the nominal transferor.

Example (1). A father gives property to his son who shortly thereafter conveys the property to a partnership consisting of the father and the son. The partnership interest of the son may be considered created by gift and the father may be considered the donor of the son's partnership interest.

Example (2). A father, the owner of a business conducted as a sole proprietorship, transfers the business to a partnership consisting of his wife and himself. The wife subsequently conveys such interest to their son. In such case, the father, as well as the mother, may be considered the donor of the son's partnership interest.

Example (3). A father makes a gift to his son of stock in the family corporation. The corporation is subsequently liquidated. The son later contributes the property received in the liquidation of the corporation to a partnership consisting of his father and himself. In such case, the son's partnership interest may be considered created by gift and the father may be considered the donor of his son's partnership interest.

(2) The allocation rules set forth in section 191 and paragraph (a) of this section apply in any case in which the transfer or creation of the partnership interest has any of the substantial characteristics of a gift. Thus, allocation may be required where transfer of a partnership interest is made between members of a family (including collaterals) under a purported purchase agreement, if the characteristics of a gift are ascertained from the terms of the purchase agreement, the terms of any loan or credit arrangements made to finance the purchase, or from other relevant data.

(3) In the case of limited partnership, for the purpose of the allocation provisions of paragraph (a) of this section, proper weight shall be given to the fact that a general partner, unlike the limited partner, risks his credit in the partnership business.

SUPPLEMENT G—INSURANCE COMPANIES

§ 39.201 *Statutory provisions; tax on life insurance companies.*

SEC. 201. *Life insurance companies*—(a) *Imposition of tax*—(1) *In general.* There shall be levied, collected, and paid for each taxable year upon the adjusted normal-tax net income (as defined in section 202) and upon the adjusted corporation surtax net income (as defined in section 203) of every life insurance company taxes computed as provided in section 13 (b) and in section 15 (b). In lieu of the taxes imposed by the preceding sentence, there shall be levied, collected, and paid for taxable years beginning in 1951 and 1952 upon the 1951 and 1952 adjusted normal-tax net income (as defined in section 203A) of every life insurance company a tax equal to the sum of the following:

3¾ per centum of the amount thereof not in excess of $200,000, plus

6½ per centum of the amount thereof in excess of $200,000.

(2) *Foreign life insurance companies.* A foreign life insurance company carrying on a life insurance business within the United States if with respect to its United States business it would qualify as a life insurance company under subsection (b) shall be taxable in the same manner as a domestic life insurance company except that the determinations necessary for the purposes of this chapter shall be made on the basis of the income, disbursements, assets, and liabilities reported in the annual statement for the taxable year of the United States business of such company on the form approved for life insurance companies by the National Association of Insurance Commissioners.

(3) *No United States insurance business.* Foreign life 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.

(b) *Definition of life insurance company.* When used in this chapter, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, and the life insurance reserves (as defined in subsection (c) (2)) plus unearned premiums and unpaid losses on noncancellable life, health, or accident policies not included in life insurance reserves, of which comprise more than 50 per centum of its total reserves. For the purpose of this subsection, total reserves means life insurance reserves, unearned premiums and unpaid losses not included in life insurance reserves, and all other insurance reserves required by law. For taxable years beginning after December 31, 1943, a burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxable under this section but shall be taxable under section 204 or section 207.

(c) *Other definitions.* In the case of a life insurance company—

(1) *Gross income.* The term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

(2) *Life insurance reserves.* The term "life insurance reserves" means amounts which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancelable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies. Such life insurance reserves, except in the case of 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 and except as hereinafter provided in the case of assessment life insurance, must also be required by law. In the case of an assessment life insurance company or association the term "life insurance reserves" includes sums actually deposited by such 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 or association, or bylaws approved by State Insurance Commissioner of such 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.

(3) *Adjusted reserves.* The term "adjusted reserves" means life insurance reserves plus 7 per centum of that portion of such reserves as are computed on a preliminary term basis.

(4) *Reserve earnings rate.* The term "reserve earnings rate" means a rate computed by adding 2.1125 per centum (65 per centum of 3¼ per centum) to 35 per centum of the average rate of interest assumed in computing life insurance reserves. Such average rate shall be calculated by multiplying each assumed rate of interest by the means of the amounts of the adjusted reserves computed at that rate at the beginning and end of the taxable year and dividing the sum of the products by the mean of the total adjusted reserves at the beginning and end of the taxable year.

(5) *Reserve for deferred dividends.* The term "reserve for deferred dividends" means 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.

(6) *Interest paid.* The term "interest paid" means—

(A) All interest paid 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 taxation under this chapter, and

(B) All amounts in the nature of interest, whether or not guaranteed, paid within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve, at the time of payment, life, health, or accident contingencies.

(7) *Net income.* The term "net income" means the gross income less—

(A) *Tax-free interest.* The amount of interest received during the taxable year which under section 22 (b) (4) is excluded from gross income;

(B) *Investment expenses.* Investment expenses paid during the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this subparagraph shall not exceed one-fourth of 1 per centum of the mean of the book value of the invested assets held at the beginning and end of the taxable year plus one-fourth of the

amount by which net income computed without any deduction for investment expenses allowed by this subparagraph, or for tax-free interest allowed by subparagraph (A), exceeds 3¾ per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year;

(C) *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;

(D) *Depreciation.* A reasonable allowance, as provided in section 23 (l), for the exhaustion, wear and tear of property, including a reasonable allowance for obsolescence.

(d) *Rental value of real estate.* The deduction under subsection (c) (7) (C) or (c) (7) (D) 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.

(e) *Amortization of premium and accrual of discount.* The gross income, the deduction provided in section 201 (c) (7) (A) and the credit allowed against net income in section 26 (a) shall each be decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a life insurance company. Such amortization and accrual shall be determined (1) in accordance with the method regularly employed by such company, if such method is reasonable, and (2) in all other cases, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary.

(f) *Double deductions.* Nothing in this section or in section 202, 203, or 203A shall be construed to permit the same items to be twice deducted.

(g) *Credits under section 26.* For the purposes of this section, in computing normal tax net income and corporation surtax net income, the credits provided in section 26 shall be allowed in the manner and to the extent provided in sections 13 (a) and 15 (a).

[Sec. 201 as amended by sec. 203, Rev. Act 1939; sec. 163 (a), Rev. Act 1942; sec. 121 (g) (3), Rev. Act 1950; sec. 336 (a) and (c), Rev. Act 1951; Pub. Law 468 (82d Cong.)]

§ 39.201-1 *Tax on life insurance companies.* (a) Except as otherwise provided in § 39.203A-1 with respect to taxable years beginning in 1952, all life insurance companies (including a foreign life insurance company carrying on a life insurance business within the United States if with respect to its United States business it would qualify as a life insurance company under section 201 (b)) are subject to both normal tax and surtax. The normal tax is imposed on the adjusted normal-tax net income (as defined in section 202) and the surtax is imposed on the adjusted corporation surtax net income (as defined in section 203) at the rates provided in section 13 (b) and in section 15 (b)

(b) The net income of life insurance companies differs from the net income of other corporations. See section 201 (c) Life insurance companies are entitled, in computing normal-tax net income and corporation surtax net income, to the credits provided in section 26 in the manner and to the extent provided in sections 13 (a) and 15 (a) respectively. The gross income, the deduction under section 201 (c) (7) (A) for wholly tax-exempt interest, and the credit under section 26 (a) for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. See section 201 (e) and § 39.201-9. Such companies are not subject to the provisions of section 117 (capital gains and losses) nor to the provisions of section 125 (amortizable bond premium) For computation of the adjusted normal-tax net income from normal-tax net income and the adjusted corporation surtax net income from corporation surtax net income, see §§ 39.202-1, 39.202-2, and 39.203-1. For computation of the 1952 adjusted normal-tax net income from the normal tax net income for such year, see §§ 39.203A-1 and 39.203A-2.

(c) All provisions of the Internal Revenue Code and of these regulations not inconsistent with the specific provisions of sections 201 to 203A, inclusive, are applicable to the assessment and collection of the tax imposed by section 201 (a) 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.

(d) Foreign life insurance companies not carrying on an insurance business within the United States are not taxable under section 201 (a) but are taxable as other foreign corporations. See section 231.

§ 39.201-2 *Foreign life insurance companies.* A foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 201 (b), is taxable on its income received during the taxable year from interest, dividends, and rents, from sources within and without the United States, pertaining to its United States business. Such a company is taxable in the same manner as a domestic life insurance company except that the determinations necessary for the purposes of chapter 1, such as gross income, the adjustment for certain reserves, deductions and limitations on deductions, amortization of premiums and accrual of discount, and the credits provided in section 26, shall be made on the basis of the income, disbursements, assets, and liabilities reported in the annual statement for the taxable year of the United States business of such company on the form approved for life insurance companies by the National Association of Life Insurance Commissioners. This statement is presumed clearly to reflect the income, disbursements, assets, and liabilities of the United States business of the company and in so far as it is not inconsistent with the provisions of the Internal Revenue Code will be recognized and used as a basis for that purpose.

§ 39.201-3 *Life insurance companies; definition.* The term "life insurance company" as used in chapter 1 is defined in section 201 (b) In determining whether an insurance company is a life insurance company, the life insurance reserves (as defined in section 201 (c) (2)) plus any unearned premiums and unpaid losses on noncancelable life, health, or accident policies, not included in "life insurance reserves" must comprise more than 50 percent of its total reserves (as defined in section 201 (b)) An insurance company writing only noncancelable life, health, or accident policies and having no "life insurance reserves" may qualify as a life insurance company if its unearned premiums and unpaid losses on such policies comprise more than 50 percent of its total reserves. A noncancelable insurance policy means a contract which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premium must be carried to cover that obligation. A burial or funeral benefit insurance company qualifying as a life insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services will be taxable under section 204 or section 207 as an insurance company other than life. For the definition of an insurance company see § 39.3797-7.

§ 39.201-4 *Life insurance reserves.* (a) The term "life insurance reserves" is defined in section 201 (c) (2) Generally, such reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. In the case of cancelable health and accident policies and similar cancelable contracts, the unearned premiums held to cover the risk for the unexpired period covered by the premiums are not included in life insurance reserves. Unpaid loss reserves for noncancelable health and accident policies are included in life insurance reserves if they are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest.

(b) In the case of an assessment life insurance company or association, life insurance reserves include sums actually deposited by such 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 or association of such company or association, or by-laws (approved by the State

insurance commissioner) of such 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.

(c) Life insurance reserves, except as otherwise provided in section 201 (c) (2) must be required by law 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, life insurance reserves do 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, and unpaid brokerage; nor do they include the net value of risks reinsured in other solvent companies; liability for premiums paid in advance; liability for annual and deferred dividends declared or apportioned; liability for dividends left on deposit at interest; liability for accrued but unsettled policy claims whether known or unreported; liability for supplementary contracts not involving, at the time with respect to which the liability is computed, life, health or accident contingencies.

(d) 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. Only reserves which are required by law or insurance department ruling, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will, except as otherwise specifically provided in section 201 (c) (2) be considered as life insurance reserves. A company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

(e) 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 mortality or morbidity tables covering disability benefits of the kind contained in policies issued by this particular class of companies but they need not be required by law.

§ 39.201-5 *Interest paid.* Interest paid is one of the elements to be used, together with adjusted reserves, reserve earnings rate, and reserve for deferred dividends, in arriving at the figure to be determined and proclaimed by the Secretary under the formula set forth in section 202 (b) See § 39.202-1. Interest paid is also one of the elements to be used in computing the amount of "required interest" for purposes of determining the reserve interest credit provided in section 203A in the case of taxable years beginning in 1952. See § 39.203A-2. Interest paid consists of (a) interest paid on indebtedness (except indebtedness incurred or continued to purchase or carry tax-exempt securities as set forth in section 201 (c) (6) (A)) and (b) amounts in the nature of interest paid on certain contracts, as provided in section 201 (c) (6) (B) Interest on indebtedness includes interest on dividends held on deposit and surrendered during the taxable year but does not include interest paid on deferred dividends the reserve for which is used in determining the policy and other liability credit provided in section 202 (b) Life insurance reserves as defined in § 39.201-4 are not indebtedness. Dividends left with the company to accumulate at interest are a debt and not a reserve liability. Amounts in the nature of interest include so-called excess-interest dividends as well as guaranteed interest paid within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve at the time of payment, life, health, or accident contingencies. It is immaterial whether the optional mode of settlement specified in the insurance or annuity contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by a beneficiary after the policy has matured, frequently referred to as a supplementary contract not involving life contingencies; for example, a contract to pay the insurance benefit in 10 annual installments. No distinction is made based on the person choosing the method of payment and the full amount of the interest paid and not merely the guaranteed interest is considered as interest paid.

§ 39.201-6 *Adjusted reserves.* For the purpose of determining the figure to be proclaimed by the Secretary under the formula set forth in section 202 (b) and also for the purpose of determining "required interest" for taxable years beginning in 1952, certain reserves computed on a preliminary term method are to be adjusted by increasing such reserves by 7 percent (see § 39.202-1) The reserves to be thus adjusted are reserves computed on preliminary term methods, such as the Illinois Standard, or the Select and Ultimate methods. Only reserves on policies in the modification period are to be so adjusted. Where reserves under a preliminary term method are the same as on the level premium method, and in the case of reserves for extended or paid-up insurance, no adjustment is to be made. The reserves as thus adjusted, and the rate of interest on which they are computed should be reported in Schedule A, Form 1120L.

§ 39.201-7 *Net income and deductions*—(a) *In general.* The net income of a life insurance company is its gross amount of income received during the taxable year from interest, dividends, and rents, less the deductions provided in section 201 (c) (7) for wholly tax-exempt interest, investment expenses, real estate expenses, and depreciation. In addition to the limitations on deductions relating to real estate owned and occupied by a life insurance company provided in section 201 (d), the limitations on the adjustment for amortization of premium and accrual of discount provided in section 201 (e), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 201 (c) (7) (B), life insurance companies are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 24 (a) (5) Life insurance companies are not entitled to the net operating loss deduction provided in section 23 (s)

(b) *Wholly tax-exempt 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 201 (c) (1) is allowed as a deduction from gross income by section 201 (c) (7) (A)

(c) *Investment expenses.* (1) As used in the Internal Revenue Code, the term "general expenses" 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 201 (c) (7) (B) subjects the entire deduction for investment expenses to the limitation provided in that section. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes.

(2) 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.

(3) Invested assets for the purpose of section 201 (c) (7) (B) and this section are those which are owned and used, and to the extent used, for the purpose of producing the income specified in section 201 (c) (1) They do not include real estate owned and occupied, and to the extent owned and occupied, by the company. If general expenses are assigned to or included in investment expenses, the maximum allowance will not be granted unless it is shown to the satisfaction of the Commissioner that such allowance is justified by a reasonable assignment of actual expenses.

(d) *Taxes and expenses with respect to real estate.* The deduction for taxes and expenses under section 201 (c) (7) (C) 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 shareholder. 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 paragraph (c) of this section. As to real estate owned and occupied by the company, see § 39.201-8.

(e) *Depreciation.* The deduction allowed for depreciation is, except as provided in section 201 (d) identical 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 201 (c) (1)

§ 39.201-8 *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 section, 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.

§ 39.201-9 *Amortization of premium and accrual of discount.* (a) Section 201 (e) provides for certain adjustments on account of amortization of premium and accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases, and for accrual of discount increases, (1) the gross income, (2) the deduction for wholly tax-exempt interest, and (3) the credit for partially tax-exempt interest.

(b) The premium for any such security is the excess of its acquisition value over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, then its fair market value. The maturity value of any such security is the amount payable thereunder either at the maturity date or an earlier call date. The earlier call date of any such security may be the earliest call date specified therein as a day certain, the earliest interest payment date if it is callable or payable at such date, the earliest date at which it is callable at par, or such other call or payment date, prior to maturity, specified in the security as may be selected by the life insurance company. A life insurance company which adjusts amortization of premium or accrual of discount with reference to a particular call or payment date must make the adjustments with reference to the value on such date and may not, after selecting such date, use a different call or payment date, or value, in the calculation of such amortization or discount with respect to such security unless the security was not in fact called or paid on such selected date.

(c) The adjustments for amortization of premium and accrual of discount will be determined:

(1) According to the method regularly employed by the company, if such method is reasonable, or

(2) According to the method prescribed by this section.

A method of amortization of premium or accrual of discount will be deemed "regularly employed" by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before made such adjustments, the company initiates in the first taxable year for which the adjustments are made a reasonable method of amortization of premium or accrual of discount and consistently follows such method thereafter. Ordinarily, a company regularly employs a method in accordance with the statute of some State, Territory, or the District of Columbia, in which it operates.

(d) The method of amortization and accrual prescribed by this section is as follows:

(1) The premium (or discount) shall be determined in accordance with this section; and

(2) The appropriate amortization of premium (or accrual of discount) attributable to the taxable year shall be an amount which bears the same ratio to the premium (or discount) as the number of months in the taxable year during which the security was owned by the life insurance company bears to the number of months between the date of acquisition of the security and its maturity or earlier call date, determined in accordance with this section. For the purpose of this section, 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.

§ 39.202 *Statutory provisions; life insurance companies; adjusted normal-tax net income.*

SEC. 202. *Adjusted normal-tax net income*—(a) *Definition.* For the purposes of section 201, the term "adjusted normal-tax net income" means the normal-tax net income minus the reserve and other policy liability credit provided in subsection (b) and plus the amount of the adjustment for certain reserves provided in subsection (c).

(b) *Reserve and other policy liability credit.* As used in this section the term "reserve and other policy liability credit" means an amount computed by multiplying the normal-tax net income by a figure, to be determined and proclaimed by the Secretary for each taxable year. This figure shall be based on such data with respect to life insurance companies for the preceding taxable year as the Secretary considers representative and shall be computed as follows:

(1) *In general.* Except as provided in paragraph (2), the figure shall be computed in accordance with the following formula: The ratio which a numerator comprised of the aggregate of the sums of (A) 2 per centum of the reserves for deferred dividends, (B) interest paid, and (C) the product of (i) the mean of the adjusted reserves at the beginning and end of the taxable year and (ii) the reserve earnings rate bears to a denominator comprised of the aggregate of the excess of net incomes computed without any deduction for tax-free interest, over the adjustment for certain reserves provided in subsection (c).

(2) *Special rule for 1949 and 1950.* * * *

(c) *Adjustment for certain reserves.* In the case of a life insurance company writing contracts other than life insurance or annuity contracts (either separately or combined with noncancellable health and accident insurance), the term "adjustment for certain reserves" means an amount equal to 3¼ per centum of the unearned premiums and unpaid losses on such other contracts which are not included in life insurance reserves. For the purposes of this subsection such unearned premiums shall not be considered to be less than 25 per centum of the net premiums written during the taxable year on such other contracts.

[Sec. 202 as amended by sec. 163 (a), Rev. Act 1942; sec. 401 (a), Rev. Act 1950]

§ 39.202-1 *Reserve and other policy liability credit for adjusted normal-tax net income.* (a) Life insurance companies in computing adjusted normal-tax net income are allowed a "reserve and other policy liability credit" in lieu of a deduction for the interest allowed on their reserves, for interest paid and for deferred dividends. This credit is a flat percentage of normal-tax net income. The figure is the same for all companies and is determined on the basis of the aggregate of the interest allowed on reserves, interest paid, and 2 percent of the reserves held for deferred dividends, as provided in section 202 (b) for all companies. The figure for each taxable year is to be determined and proclaimed by the Secretary, based on such data with respect to life insurance companies for the preceding taxable year as the Secretary considers representative for such year.

(b) The application of the reserve and other policy liability credit for the purpose of this section and section 203 may be illustrated by the following examples:

Example (1). The X Life Insurance Company for the calendar year 1942 had gross income, consisting of interest and rents, of $4,000,000, of which $700,000 consists of wholly tax-exempt interest. It had investment expenses of $100,000, real estate expenses of $80,000, and depreciation of $20,000. Its net income and its normal-tax net income was accordingly $3,100,000 ($4,000,000 less investment expenses, real estate expenses, and depreciation, totaling $200,000, and wholly tax-exempt interest of $700,000).

Since the Secretary determined and proclaimed that for the taxable year 1942 the figure based on data for the taxable year 1941 is 0.93, the X Life Insurance Company was entitled to a credit of $2,883,000 ($3,100,000×0.93) and its adjusted normal-tax net income as well as its adjusted corporation surtax net income was $217,000 ($3,100,000−$2,883,000).

Example (2). If in example (1) $100,000 of the $4,000,000 gross income of the X Life Insurance Company for the calendar year 1942 consisted of partially tax-exempt interest, in addition to the $700,000 of wholly tax-exempt interest, its corporation surtax net income and adjusted corporation surtax net income would be the same as in the above example. Its normal-tax net income, however, would be $3,000,000 ($4,000,000 less $200,000 less $700,000 less $100,000), its credit would be $2,790,000 ($3,000,000×0.93) and its adjusted normal-tax net income would be $210,000 ($3,000,000−$2,790,000).

§ 39.202–2 *Adjustment for certain reserves.* (a) A life insurance company writing contracts other than life insurance or annuity contracts (either separately or combined with noncancellable health and accident insurance contracts) must add to its normal-tax net income and to its corporation surtax net income, as an offset to its reserve and other policy liability credit, an amount equal to 3¼ percent of the mean of the unearned premiums and unpaid losses at the beginning and end of the taxable year on such other contracts as are not included in life insurance reserves. If such unearned premiums, however, are less than 25 percent of the net premiums written during the taxable year on such other contracts, then the amount to be added to normal-tax net income and to corporation surtax net income is 3¼ percent of 25 percent of the net premiums written during the taxable year on such other contracts plus 3¼ percent of the mean of the unpaid losses at the beginning and end of the taxable year on such other contracts. As used in this section, the term "unearned premiums" has the same meaning as in section 204 (b) (5) and § 39.204–2.

(b) For taxable years beginning in 1952, an amount equal to 8 times the amount of the applicable adjustment provided in paragraph (a) of this section, must be added to normal-tax net income for such year as a factor in determining 1952 adjusted normal-tax net income.

§ 39.203 *Statutory provisions; life insurance companies; adjusted corporation surtax net income.*

SEC. 203. *Adjusted corporation surtax net income*—(a) *Definition.* For the purposes of section 201, the term "adjusted corporation surtax net income" means the corporation surtax net income minus the reserve and other policy liability credit and plus the adjustment for certain reserves provided in section 202 (c).

(b) *Reserve and other policy liability credit.* As used in this section, the term "reserve and other policy liability credit" means an amount computed by multiplying the corporation surtax net income by the applicable figure determined and proclaimed under section 202 (b).

[Sec. 203 as amended by sec. 211 (e) (1), Rev. Act 1939; sec. 163 (a), Rev. Act 1942; sec. 401 (b), Rev. Act 1950]

§ 39.203–1 *Reserve and other policy liability credit for adjusted corporation surtax net income.* Life insurance companies in computing adjusted corporation surtax net income are allowed a reserve and other policy liability credit. This credit is similar to that provided in section 202 except that it is based on corporation surtax net income, which includes partially tax-exempt interest. See § 39.202–1 for the application and effect of this provision.

§ 39.203A *Statutory provisions; life insurance companies; 1951 and 1952 adjusted normal-tax net income.*

SEC. 203A. *1951 and 1952 adjusted normal-tax net income*—(a) *1951 and 1952 adjusted normal-tax net income.* For the purposes of section 201, the term "1951 and 1952 adjusted normal-tax net income" means the normal-tax net income plus eight times the amount of the adjustment for certain reserves provided in section 202 (c) and minus the reserve interest credit, if any, provided in subsection (b) of this section.

(b) *Reserve interest credit.* For the purposes of subsection (a), the reserve interest credit shall be an amount determined as follows:

(1) Divide the amount of the adjusted net income (as defined in subsection (c)) by the amount of the required interest (as defined in subsection (d)).

(2) If the quotient obtained in paragraph (1) is 1.05 or more, the reserve interest credit shall be zero.

(3) If the quotient obtained in paragraph (1) is 1.00 or less, the reserve interest credit shall be an amount equal to 50 per centum of the normal-tax net income.

(4) If the quotient obtained in paragraph (1) is more than 1.00 but less than 1.05, the reserve interest credit shall be the amount obtained by multiplying the normal-tax net income by 10 times the difference between the figures 1.05 and such quotient.

(c) *Adjusted net income.* For the purposes of subsection (b) (1), the term "adjusted net income" means the net income computed without any deduction for tax-free interest minus 50 per centum of the amount of the adjustment for certain reserves provided in section 202 (c).

(d) *Required interest.* For the purposes of subsection (b) (1), the term "required interest" means the total of—

(1) The sum of the amounts obtained by multiplying (A) each rate of interest assumed in computing the taxpayer's life insurance reserves by (B) the means of the amounts of the taxpayer's adjusted reserves computed at that rate at the beginning and end of the taxable year,

(2) 2 per centum of the reserve for deferred dividends, and

(3) Interest paid.

[Sec. 203A as added by sec. 336 (b), Rev. Act 1951, amended by sec. 1 (b); Pub. Law 468, (82d Cong.)]

§ 39.203A–1 *Tax on life insurance companies in the case of a taxable year beginning in 1952.* (a) In the case of a taxable year beginning in 1952, the tax imposed on a life insurance company for such year shall consist of a tax upon the 1952 adjusted normal-tax net income of the company equal to 3¾ percent of the amount of such income not in excess of $200,000, plus 6½ percent of the amount of such income in excess of $200,000. The term "1952 adjusted normal-tax net income" means the normal-tax net income (consisting of net income computed as provided in § 39.201–7 less the credit for partially tax-exempt interest allowed under section 26 (a) and less the credit for dividends received allowed under section 26 (b)) for the taxable year beginning in 1952 plus eight times the amount of the adjustment for certain reserves computed as provided in section 202 (c) (see § 39.202–2), and minus the reserve interest credit, if any, provided in section 203A (b) (see § 39.203A–2) The reserve and other policy liability credit is not allowed for purposes of the computation of 1952 adjusted normal-tax net income.

(b) The tax imposed upon 1952 adjusted normal-tax net income by section 201 (a) is in lieu of the tax otherwise imposed on adjusted normal-tax net income and adjusted corporation surtax net income by section 201 (a)

§ 39.203A–2 *Reserve interest credit.* (a) In computing 1952 adjusted normal-tax net income, a reserve interest credit is allowed where the "adjusted net income" of the company is less than 105 percent of its required interest. For the purpose of computing the reserve interest credit, the term "adjusted net income" means the net income of the company without any deduction for tax-free interest otherwise allowed by section 201 (c) (7) (A) less 50 percent of the adjustment for certain reserves on contracts other than life insurance or annuity contracts provided in section 202 (c)

(b) The required interest for which a credit may be allowed consists of the total of:

(1) The sum of amounts obtained by multiplying each rate of interest assumed in computing life insurance reserves (see section 201 (c) (2) and § 39.201–4) by the means of the amounts of the adjusted reserves, as defined in section 201 (c) (3), computed at that rate at the beginning and the end of the taxable year;

(2) Two percent of the reserve for deferred dividends; and

(3) Interest paid.

(c) To determine the amount of the reserve interest credit, it is necessary to divide the amount of the adjusted net income by the amount of the required interest. If the adjusted net income is 100 percent or less of the required interest, the reserve interest credit is an amount equal to 50 percent of the normal-tax net income. If the adjusted net income is 105 percent or more of the required interest, the reserve interest credit is zero. If the adjusted net income is more than 100 percent and less than 105 percent of the required interest, the reserve interest credit is computed by multiplying the normal-tax net income by ten times the difference between 105 percent and the percentage established. Thus, if the adjusted net income of a life insurance company for the calendar year 1952 is $103,000 and the required interest for such year is $100,000, the adjusted net income is 103 percent of the required interest and the reserve interest, accordingly, is the normal-tax net income multiplied by 20 percent (10 times 2 percent, the difference between 105 percent and 103 percent)

(d) In determining the percentage of the adjusted net income to required interest for purposes of determining the reserve interest credit, the figures shall be computed to at least the nearest one-tenth of a percentage point.

§ 39.204 *Statutory provisions; tax on insurance companies other than life or mutual.*

SEC. 204. *Insurance companies other than life or mutual*—(a) *Imposition of tax*—(1) *In general.* There shall be levied, collected, and paid for each taxable year upon the normal-tax net income and upon the corporation surtax net income of every insurance company (other than a life or mutual insurance company) and every mutual marine insurance company and every mutual fire insurance company exclusively issuing either perpetual policies, or policies for which the sole premium charged is a single deposit which (except for such deduction of underwriting costs as may be provided) is refundable upon cancellation or expiration of the policy taxes computed as provided in section 13 (b) and in section 15 (b).

(2) *Normal-tax and corporation surtax net income of foreign insurance companies other than life or mutual and foreign mutual marine.* In the case of a foreign insurance company (other than a life or mutual insurance company) and a foreign mutual marine insurance company and a foreign mutual fire insurance company described in paragraph (1) of this subsection, the normal-tax net income shall be the net income from sources within the United States minus the credit provided in section 26 (a) and the credit provided in section 26 (b), and the corporation surtax net income shall be the net income from sources within the United States minus the credit provided in section 26 (b).

(3) *No United States insurance business.* Foreign insurance companies (other than a life or mutual insurance company) and foreign mutual marine insurance companies and foreign mutual fire insurance companies described in paragraph (1) of this subsection 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.

(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; except that in the case of a mutual fire insurance company described in paragraph (1) of subsection (a) of this section, the amount of single deposit premiums paid to such company shall not be included in gross income;

(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. For the purposes of this subsection, unearned premiums shall include life insurance reserves, as defined in section 201 (c) (2), pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by this section and not qualifying as a life insurance company under section 201 (b);

(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.

(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) *Capital losses.* Capital losses to the extent provided in section 117 plus losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Capital assets shall be considered as sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders to the extent that the gross receipts from their sale or exchange are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders in their capacity as such, losses paid, and expenses paid over the sum of interest, dividends, rents, and net premiums received. In the application of section 117 (e) for the purposes of this section, the net capital loss for the taxable year shall be the amount by which losses for such year from sales or exchanges of capital assets exceeds the sum of the gains from such sales or exchanges and whichever of the following amounts is the lesser:

(A) The corporation surtax net income (computed without regard to gains or losses from sales or exchanges of capital assets); or

(B) Losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders;

(6) Debts in the nature of agency balances and bills receivable which become worthless 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;

(11) Dividends and similar distributions paid or declared to policyholders in their capacity as such, except in the case of a mutual fire insurance company described in paragraph (1) of subsection (a) of this section. The term "paid or declared" shall be construed according to the method of accounting regularly employed in keeping the books of the insurance company.

(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.

(e) *Double deductions.* Nothing in this section shall be construed to permit the same item to be twice deducted.

(f) *Credits under section 26.* For the purposes of this section, in computing normal-tax net income and corporation surtax net income, the credits provided in section 26 shall be allowed in the manner and to the extent provided in sections 13 (a) and (15) (a).

[Sec. 204 as amended by secs. 204 and 226 (a), Rev. Act 1939; secs. 124 (b), 160 (d), and 164, Rev. Act 1942; sec. 135, Rev. Act 1943; sec. 122 (g) (7), Rev. Act 1945; sec. 121 (g) (4), Rev. Act 1950]

§ 39.204-1 *Tax on insurance companies other than life or mutual, mutual marine insurance companies, and mutual fire insurance companies issuing perpetual policies.* (a) All insurance companies, other than life or mutual or foreign insurance companies not carrying on an insurance business within the United States, and all mutual marine insurance companies and mutual fire insurance companies exclusively issuing either perpetual policies, or policies for which the sole premium charged is a single deposit which, except for such deduction of underwriting costs as may be provided, is refundable upon cancellation or expiration of the policy, are subject to the tax imposed by section 204. As used in this section and §§ 39.204-2 and 39.204-3, the term "insurance companies" means only those companies subject to the tax imposed by section 204. For what constitutes an insurance company, see § 39.3797-7. The net income of insurance companies is defined in section 204 and differs from the net income of other corporations. All provisions of the Internal Revenue Code 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 returns under section 204 shall be made on the basis of the calendar year and shall be on Form 1120. Insurance companies are entitled, in computing normal-tax net income and corporation surtax net income, to the credits provided in section 26 in the manner and to the extent provided in sections 13 (a) and 15 (a)

(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.

(c) Insurance companies are subject to both normal tax and surtax. The normal tax shall be computed as provided in section 13 (b) For what constitutes normal-tax net income, see § 39.13-1. The surtax shall be computed as provided in section 15 (b) For what constitutes corporation surtax net income, see § 39.15-1. For the circumstances under which the $25,000 exemption from surtax for certain taxable years may be disallowed in whole or in part, see § 39.15-2. For alternative tax where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 117 (c) and the regulations thereunder.

§ 39.204-2 *Gross income.* (a) 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, except that in the case of a mutual fire insurance company described in § 39.204-1 the amount of single deposit premiums received, but not assessments, shall be excluded from gross income. 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 the home office of a foreign insurance company to the United States branch, borrowed money, or gross increase due to adjustments in book value of capital assets. The underwriting and investment exhibit is presumed clearly to reflect the true net income of the company and insofar as it is not inconsistent with the provisions of the Internal Revenue Code 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 Code. 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 to shareholders in their capacity as such, 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 allowed as deductions for worthless debts or, having been previously so allowed, are recovered during the taxable year. In computing "premiums earned on insurance contracts during the taxable year" the amount of the unearned premiums shall include (1) life insurance reserves as defined in section 201 (c) (2) and § 39.201-4 pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 204 and not qualifying as a life insurance company under section 201 (b) and (2) liability for return premiums under a rate credit or retrospective rating plan based on experience, such as the "War Department Insurance Rating Plan," and which return premiums are therefore not earned premiums. In computing "losses incurred" the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the Commissioner of Internal Revenue that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the Commissioner, are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The Commissioner may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

(c) That part of the deduction for "losses incurred" which represents an adjustment to "losses paid" for "salvage and reinsurance recoverable" shall, except as hereinafter provided, include all salvage in course of liquidation, and all reinsurance in process of collection not otherwise taken into account as a reduction of "losses paid," outstanding at the end of the taxable year. Salvage in course of liquidation includes all property (other than cash), real or personal, tangible or intangible, except that which may not be included by reason of express statutory provisions (or rules and regulations of an insurance department) of any State or Territory or the District of Columbia in which the company transacts business. Such salvage in course of liquidation shall be taken into account to the extent of the value thereof at the end of the taxable year as determined from a fair and reasonable estimate based upon either the facts in each case or the company's experience with similar cases. Cash received during the taxable year with respect to items of salvage or reinsurance shall be taken into account in computing losses paid during such taxable year.

§ 39.204-3. *Deductions.* (a) The deductions allowable are specified in section 204 (c) and by reason of the provisions of section 204 (c) (10) include deductions (other than those specified in section 204 (c)) as provided in section 23. The deductions, however, are subject to the limitation provided in section 24 (a) (5) The net operating loss deduction allowed by section 23 (s) is computed under section 122 and the regulations thereunder. In computing net operating loss or net income of insurance companies for the purposes of section 122, "gross income" shall mean gross income as defined in section 204 (b) (1) and the allowable deductions shall be those allowed by section 204 (c) with the exceptions and limitations set forth in section 122 (d) In addition to the deduction for capital losses provided in section 117, insurance companies are allowed a deduction for losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. A special rule is provided for the application of the 5-year capital loss carry-over provisions of section 117 (e) The deduction is the same as that allowed mutual insurance companies subject to the tax imposed by section 207, see section 207 (b) (4) (F) and the regulations thereunder. Insurance companies, other than mutual fire insurance companies described in § 39.204-1, are also allowed a deduction for dividends and similar distributions paid or declared to policyholders in their capacity as such. The deduction is otherwise the same as that allowed mutual insurance companies subject to the tax imposed by section 207, see section 207 (b) (3) and the regulations thereunder.

(b) 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 chooses to claim to any extent a credit for such taxes) taxes assessed against local benefits, 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 in their capacity as such, remittances to the home office of a foreign insurance company by the United States branch, and borrowed money repaid.

(c) In computing net income of insurance companies, 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) (1) Insurance companies are entitled to the alternative taxes provided in section 117 (c)

§ 39.205–207 *Statutory provisions; insurance companies; taxes of foreign countries and possessions of United States; computation of gross income; tax on mutual insurance companies other than life or marine.*

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 or marine*—(a) *Imposition of tax.* There shall be levied, collected, and paid for each taxable year upon the income of every mutual insurance company (other than a life or a marine insurance company or a fire insurance company subject to the tax imposed by section 204 and other than an interinsurer or reciprocal underwriter) a tax computed under paragraph (1) or paragraph (2) whichever is the greater and upon the income of every mutual insurance company (other than a life or marine insurance company or a fire insurance company subject to the tax imposed by section 204) which is an interinsurer or reciprocal underwriter, a tax computed under paragraph (3)

(1) If the corporation surtax net income is over $3,000 a tax computed as follows:

(A) *Taxable years beginning after December 31, 1950, and before April 1, 1951.* * * *

(B) *Taxable years beginning after March 31, 1951, and before April 1, 1954.* In the case of taxable years beginning after March 31, 1951, and before April 1, 1954—

(i) *Normal tax.* A normal tax of 30 per centum of the normal-tax net income, or 60 per centum of the amount by which the normal-tax net income exceeds $3,000, whichever is the lesser; plus

(ii) *Surtax.* A surtax of 22 per centum of the corporation surtax net income in excess of $25,000.

(C) *Taxable years beginning after March 31, 1954.* In the case of a taxable year beginning after March 31, 1954—

(i) *Normal tax.* A normal tax of 25 per centum of the normal-tax net income, or 50 per centum of the amount by which the normal-tax net income exceeds $3,000, whichever is the lesser; plus

(ii) *Surtax.* A surtax of 22 per centum of the corporation surtax net income in excess of $25,000.

(2) If for the taxable year the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus the interest which under section 22 (b) (4) is excluded from gross income, exceeds $75,000, a tax equal to the excess of—

(A) 1 per centum of the amounts so computed, or 2 per centum of the excess of the amount so computed over $75,000, whichever is the lesser, over

(B) The amount of the tax imposed under Subchapter E of Chapter 2.

(3) In the case of an interinsurer or reciprocal underwriter, if the corporation surtax net income is over $50,000 a tax computed as follows:

(A) *Taxable years beginning after December 31, 1950, and before April 1, 1951.* * * *

(B) *Taxable years beginning after March 31, 1951, and before April 1, 1954.* In the case of taxable years beginning after March 31, 1951, and before April 1, 1954—

(i) *Normal tax.* A normal tax of 30 per centum of the normal-tax net income, or 60 per centum of the amount by which the normal-tax net income exceeds $50,000, whichever is the lesser; plus

(ii) *Surtax.* A surtax of 22 per centum of the corporation surtax net income in excess of $25,000, or 33 per centum of the amount by which the corporation surtax net income exceeds $50,000, whichever is the lesser.

(C) *Taxable years beginning after March 31, 1954.* In the case of a taxable year beginning after March 31, 1954—

(i) *Normal tax.* A normal tax of 25 per centum of the normal-tax net income, or 50 per centum of the amount by which the normal-tax net income exceeds $50,000, whichever is the lesser; plus

(ii) *Surtax.* A surtax of 22 per centum of the corporation surtax net income in excess of $25,000, or 33 per centum of the amount by which the corporation surtax net income exceeds $50,000, whichever is the lesser.

(4) *Gross amount received over $75,000 but less than $125,000.* If the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 but less than $125,000 the amount ascertained under paragraph (1), paragraph (2) (A), and paragraph (3) shall be an amount which bears the same proportion to the amount ascertained under such paragraph, computed without reference to this paragraph, as the excess over $75,000 of such gross amount received bears to $50,000.

(5) *Foreign mutual insurance companies other than life or marine.* In the case of a foreign mutual insurance company (other than a life or marine insurance company or a fire insurance company subject to the tax imposed by section 204), the net income shall be the net income from sources within the United States and the gross amount of income from interest, dividends, rents, and net premiums shall be the amount of such income from sources within the United States.

(6) *No United States insurance business.* Foreign mutual insurance companies (other than a life or marine insurance company or a fire insurance company subject to the tax imposed by section 204) 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.

(b) *Definition of income, etc.* In the case of an insurance company subject to the tax imposed by this section—

(1) *Gross investment income.* "Gross investment income" means the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets to the extent provided in section 117;

(2) *Net premiums.* "Net premiums" means gross premiums (including deposits and assessments) written or received on insurance contracts during the taxable year less return premiums and premiums paid or incurred for reinsurance. Amounts returned where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management shall not be included in return premiums but shall be treated as dividends to policyholders under paragraph (3);

(3) *Dividends to policyholders.* "Dividends to policyholders" means dividends and similar distributions paid or declared to policyholders. The term "paid or declared" shall be construed according to the method regularly employed in keeping the books of the insurance company;

(4) *Net income.* The term "net income" means the gross investment income less—

(A) *Tax-free interest.* The amount of interest which under section 22 (b) (4) is excluded for the taxable year from gross income;

(B) *Investment expenses.* Investment expenses paid or accrued during the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this subparagraph shall not exceed one-fourth of 1 per centum of the mean of the book value of the invested assets held at the beginning and end of the taxable year plus one-fourth of the amount by which net income computed without any deduction for investment expenses allowed by this subparagraph, or for tax-free interest allowed by subsection (b) (4) (A), exceeds 3¾ per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

(C) *Real estate expenses.* Taxes and other expenses paid or accrued 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 or accrued 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;

(D) *Depreciation.* A reasonable allowance, as provided in section 23 (l), for the exhaustion, wear and tear of property, including a reasonable allowance for obsolescence;

(E) *Interest paid or accrued.* 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 taxation under this chapter.

(F) *Capital losses.* Capital losses to the extent provided in section 117 plus losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Capital assets shall be considered as sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders to the extent that the gross receipts from their sale or exchange are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, losses paid, and expenses paid over the sum of interest, dividends, rents, and net premiums received. In the application of section 117 (e) for the purposes of this section, the net capital loss for the taxable year shall be the amount by which losses for such year from sales or exchanges of capital assets exceeds the sum of the gains from such sales or exchanges and whichever of the following amounts is the lesser:

(i) The corporation surtax net income (computed without regard to gains or losses from sales or exchanges of capital assets); or

(ii) Losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders.

(c) *Rental value of real estate.* The deduction under subsection (b) (4) (C) or (b) (4) (D) of this section on account of any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by this section, 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.

(d) *Amortization of premium and accrual of discount.* The gross amount of income during the taxable year from interest, the deduction provided in subsection (b) (4) (A), and the credit allowed against net income in section 26 (a) shall each be decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by this section. Such amortization and accrual shall be determined (1) in accordance with the method regularly employed by such company, if such method is reasonable, and (2) in all other cases, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary.

(e) *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.

(f) *Double deductions.* Nothing in this section shall be construed to permit the same item to be twice deducted.

(g) *Credits under section 26.* For the purposes of this section, in computing normal tax net income and corporation surtax net income, the credits provided in section 26 shall be allowed in the manner and to the extent provided in sections 13 (a) and 15 (a).

[Sec. 207 as amended by sec. 205, Rev. Act 1939; sec. 165 (b), Rev. Act 1942; sec. 135, Rev. Act 1943; sec. 121 (b), Rev. Act 1945; sec. 121 (d), Rev. Act 1950; sec. 201 (b), Excess Profits Tax Act 1950; sec. 121 (c), Rev. Act 1951]

§ 39.207-1 *Tax on mutual insurance companies other than life or marine or fire insurance companies subject to the tax imposed by section 204*—(a) *In general.* (1) All mutual insurance companies, including foreign insurance companies carrying on an insurance business within the United States, not taxable under section 201 or 204 and not specifically exempt under the provisions of section 101 (11) are subject to the tax imposed by section 207 (a) on their investment income or on their gross income, whichever tax is the greater, except interinsurers and reciprocal underwriters which are taxed only on their investment income. For the alternative tax, in lieu of the tax imposed by section 207 (a) (1) or (3) where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 117 (c) (1) and the regulations thereunder.

(2) The taxable income of mutual insurance companies subject to the tax imposed by section 207 differs from the taxable income of other corporations. See section 207 (a) (2) and section 207 (b) Such companies are entitled, in computing normal-tax net income and corporation surtax net income, to the credits provided in section 26 in the manner and to the extent provided in sections 13 (a) and 15 (a) The gross amount of income during the taxable year from interest, the deductions under section 207 (b) (4) (A) for wholly tax-exempt interest, and the credit under section 26 (a) for partially tax-exempt interest, are decreased by the appropriate amortization of premiums and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 207. See section 207 (d) and § 39.207-6.

(3) All provisions of the Internal Revenue Code and of the regulations in this part not inconsistent with the specific provisions of section 207 are applicable to the assessment and collection of the tax imposed by section 207 (a) and mutual insurance companies subject to the tax imposed by section 207 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 1120M.

(4) Foreign mutual insurance companies not carrying on an insurance business within the United States are not taxable under section 207 (a) but are taxable as other foreign corporations. See section 231.

(5) Mutual insurance companies subject to the tax imposed by section 207, except interinsurers or reciprocal underwriters, with corporation surtax net incomes of over $3,000 or with gross amounts of income from interest, dividends, rents, and net premiums (minus dividends to policyholders and wholly tax-exempt interest) in excess of $75,000, are subject to a tax computed under section 207 (a) (1) or section 207 (a) (2) whichever is the greater. Interinsurers and reciprocal underwriters with corporation surtax net incomes of over $50,000 are subject to a tax computed under section 207 (a) (3)

(b) *Rates of tax.* (1) The normal tax under section 207 (a) (1) and 207 (a) (3) except as hereinafter indicated, is computed upon normal-tax net income at the following rates:

	Percent
(i) For taxable years beginning before Apr. 1, 1954	30
(ii) For taxable years beginning after Mar. 31, 1954	25

(2) The surtax under section 207 (a) (1) and 207 (a) (3) except as hereinafter indicated, is computed on that portion of the corporation surtax net income in excess of $25,000 at the rate of 22 percent. The tax under section 207 (a) (2) except as hereinafter indicated, is 1 percent of the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest.

(3) Under section 207 (a) (1) companies with normal-tax net incomes of over $3,000 and not over $6,000 pay a normal tax, at a specified rate, on that portion of the normal-tax net income in excess of $3,000. The rates applicable in computing the normal tax of such companies are as follows:

	Percent
For taxable years beginning before Apr. 1, 1954	60
For taxable years beginning after Mar. 31, 1954	50

Under section 207 (a) (2) companies with gross amounts of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest, of over $75,000 and not over $150,000 pay a tax equal to 2 percent of that portion in excess of $75,000. Under section 207 (a) (3) interinsurers and reciprocal underwriters with normal-tax net incomes of over $50,000 and not over $100,000 pay a normal tax computed on that portion of the normal-tax net income in excess of $50,000 at the following rates:

	Percent
For taxable years beginning before Apr. 1, 1954	60
For taxable years beginning after Mar. 31, 1954	50

Under section 207 (a) (3) interinsurers and reciprocal underwriters with corporation surtax net incomes of over $50,000 and not over $100,000 pay a surtax, at the rate of 33 percent, on that portion of the corporation surtax net income in excess of $50,000.

(4) Section 207 (a) (4) provides for an adjustment of the amount computed under section 207 (a) (1) section 207 (a) (2) (A) and section 207 (a) (3) where the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 and less than $125,000. The adjustment reduces the tax otherwise computed under those sections to an amount which bears the same proportion to such tax as the excess over $75,000 bears to $50,000.

(c) *Application.* The application of section 207 (a) (1) (2), (3), and (4) may be illustrated by the following examples:

Example (1). The W Company, a mutual casualty insurance company, for the calendar year 1952 has corporation surtax net income of $5,500 and, due to partially tax-exempt interest of $800, normal-tax net income of $4,700. The gross amount of income of the W Company from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $150,000. Its normal tax under section 207 (a) (1) for the calendar year 1952 is 60 percent of $1,700 ($4,700-$3,000), or $1,020, since its normal-tax net income is not over $6,000. It is not liable for surtax for the calendar year 1952 as its surtax net income does not exceed $25,000. It has no surtax and, therefore, its total tax under section 207 (a) (1) is the normal tax of $1,020. The tax under section 207 (a) (2) is 2 percent of $75,000 ($150,000-$75,000), or $1,500. Since the tax under section 207 (a) (2) exceeds the tax under section 207 (a) (1), the tax under section 207 (a) is $1,500, namely, that imposed by section 207 (a) (2).

Example (2). If in the above example the normal-tax net income were not over $3,000, the corporation surtax net income were not

over $25,000, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) were $90,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, were $70,000, the W Company would be required to file an income tax return but due to section 207 (a) no income tax would be imposed.

Example (3). The X Company, a mutual casualty insurance company, for the calendar year 1952 has corporation surtax net income of $28,000 and, due to partially tax-exempt interest of $5,000, normal-tax net income of $23,000. The gross amount of income of the X Company from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $1,200,000. Under section 207 (a) (1) its normal tax for the calendar year 1952 is 30 percent of $23,000, or $6,900, and the surtax is 22 percent of $3,000 ($28,000–$25,000), or $660. The combined tax under section 207 (a) (1) is $7,560 ($6,900 plus $660). The tax under section 207 (a) (2) is 1 percent of $1,200,000, or $12,000. Since the tax under section 207 (a) (2) exceeds the tax under section 207 (a) (1), the tax under section 207 (a) is $12,000, namely, that imposed by section 207 (a) (2).

Example (4). The Y Company, a mutual fire insurance company subject to the tax imposed by section 207, for the calendar year 1952 has corporation surtax net income of $35,000 and, due to partially tax-exempt interest of $5,000, normal-tax net income of $30,000. The gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is $120,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $100,000. Under section 207 (a) (1), without application of section 207 (a) (4), the normal tax would be 30 percent of $30,000, or $9,000, since this is less than $16,200, 60 percent of $27,000 (excess of normal-tax net income of $30,000 over $3,000); and the surtax would be 22 percent of $10,000 (excess of corporation surtax net income of $35,000 over $25,000), or $2,200. The combined tax of $11,200 ($9,000 plus $2,200) would then be reduced by applying section 207 (a) (4), since the gross receipts are between $75,000 and $125,000. The tax under section 207 (a) (1), as thus adjusted, would be 90 percent of $11,200, or $10,080, since $45,000 (excess of $120,000 over $75,000) is 90 percent of $50,000. Under section 207 (a) (2) (A), without reference to section 207 (a) (4), the tax is 2 percent of $25,000 (excess of $100,000 over $75,000), or $500, since this is less than $1,000, 1 percent of $100,000. Applying section 207 (a) (4) reduces this to $450, or 90 percent of $500. Since $10,080, the tax under section 207 (a) (1), as adjusted, exceeds $450, the tax under section 207 (a) (2), as adjusted, the tax under section 207 (a) (1), as adjusted, is applicable. The Y Company would accordingly pay a combined normal tax and surtax of $10,080.

Example (5). The Z Exchange, an inter-insurer, for the calendar year 1952 has corporation surtax net income of $60,000 and, due to partially tax-exempt interest of $12,000, normal-tax net income of $48,000. The gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is $2,700,000. The Z Exchange is not liable for normal tax under section 207 (a) (3) for the calendar year 1952 as its normal-tax net income does not exceed $50,000. Its surtax is 33 percent of $10,000 ($60,000 minus $50,000), or $3,300, since that amount is less than $7,700, 22 percent of $35,000 (excess of corporation surtax net income of $60,000 over $25,000). Since the Z Exchange has no normal tax, is not subject to the tax imposed by section 207 (a) (2), and is not entitled to the adjustment provided in section 207 (a) (4), its total tax under section 207 (a) is $3,300.

§ 39.207–2 *Net premiums.* Net premiums are one of the items used, together with interest, dividends, and rents, less dividends to policyholders and wholly tax-exempt interest, in determining tax liability under section 207 (a) (2) They are also used in section 207 (b) (4) (F) in determining the limitation on certain capital losses and in the application of section 117 (e) The term "net premiums" is defined in section 207 (b) (2) and includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 207 (b) (3)

§ 39.207–3 *Dividends to policyholders.* (a) "Dividends to policyholders" is one of the deductions used, together with wholly tax-exempt interest, in determining tax liability under section 207 (a) (2) They are also used in section 207 (b) (4) (F) in determining the limitation on certain capital losses and in the application of section 117 (e). The term "dividends to policyholders" is defined in section 207 (b) (3) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such amounts are not to be treated as return premiums under section 207 (b) (2). Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual fire insurance companies. The term "paid or declared" is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed as follows:

To dividends and similar distributions paid during the taxable year add the amount of dividends and similar distributions declared but unpaid at the end of the taxable year and deduct dividends and similar distributions declared but unpaid at the beginning of the taxable year.

If an insurance company on the accrual basis does not use the above method in determining the deduction for dividends and similar distributions declared to policyholders, it must submit with its return a full and complete explanation of the method actually used. For the rule as to when dividends are considered paid, see § 39.27 (b)–2 (a)

§ 39.207–4 *Net income and deductions*—(a) *In general.* The net income of a mutual insurance company subject to the tax imposed by section 207 is its gross investment income, namely, the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets, less the deductions provided in section 207 (b) (4) for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accrued, and capital losses to the extent provided in section 117. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 207 provided in section 207 (c) the adjustment for amortization of premium and accrual of discount provided in section 207 (d) and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 207 (b) (4) (B) mutual insurance companies subject to the tax imposed by section 207 are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 24 (a) (5). Such companies are not entitled to the net operating loss deduction provided in section 23 (s).

(b) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 22 (b) (4) but included in the gross investment income by section 207 (b) (1) is allowed as a deduction from gross investment income by section 207 (b) (4) (A).

(c) *Investment expenses.* The deduction allowed by section 207 (b) (4) (B) for investment expenses is the same as that allowed life insurance companies by section 201 (c) (7) (B) except that provision is made for both the cash and accrual method of accounting. See § 39.201–7 (c).

(d) *Taxes and expenses with respect to real estate.* The deduction allowed by section 207 (b) (4) (C) for taxes and expenses with respect to real estate owned by the company is the same as that allowed life insurance companies by section 201 (c) (7) (C) except that provision is made for both the cash and accrual method of accounting. See § 39.201–7 (d)

(e) *Depreciation.* The deduction allowed by section 207 (b) (4) (D) for depreciation is the same as that allowed life insurance companies by section 201 (c) (7) (D). See § 39.201–7 (e)

(f) *Interest paid or accrued.* The deduction allowed by section 207 (b) (4) (E) for interest on indebtedness is the same as that allowed other corporations by section 23 (b). See § 39.23 (b)–1.

(g) *Capital losses.* (1) The deduction for capital losses under section 207 (b) (4) (F) includes not only capital losses to the extent provided in section 117 but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends

and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under section 117 is limited to the gains. See section 117 (d) (1)

(2) Capital assets are considered as sold or exchanged to provide for the funds or payments specified in section 207 (b) (4) (F) to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of interest, dividends, rents, and net premiums received. If, by reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital losses subject to the provisions of section 117. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 117 (e)

(3) The application of section 207 (b) (4) (F) may be illustrated by the following examples:

Example (1). The X Company, a mutual fire insurance company subject to the tax imposed by section 207, in the taxable year 1952 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,000. It pays dividends to policyholders of $150,000. It sustains losses of $25,000, and pays expenses of $25,000. It receives interest of $50,000, dividends of $5,000, rents of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000) is $75,000. As the gross receipts from the sale of capital assets ($60,000) do not exceed such excess ($75,000), the losses of $20,000 are allowable as a deduction from gross investment income.

Example (2). If in the above example the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under section 117.

Example (3). If in example (1) the X Company had a corporation surtax net income of $9,750 and, under the provisions of section 117, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1952, in applying section 117 (e) for the purposes of section 207 (b) (4) (F), would be $8,000. This is determined by subtracting from total losses of $38,000 ($18,000 capital losses under section 117 plus $20,000 other capital losses under section 207 (b) (4) (F)) the sum of capital gains of $10,000 and losses from the sale or exchange of capital assests sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,000 are added to capital gains of $10,000, since they are less than corporation surtax net income, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 corporation surtax net income plus $20,000 other capital losses under section 207 (b) (4) (F) plus the portion of capital losses allowable under section 117 of $10,000 minus capital gains under section 117 of $10,000).

§ 39.207-5 *Real estate owned and occupied.* The limitation in section 207 (c) on 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 mutual insurance company subject to the tax imposed by section 207 is the same as that provided in the case of life insurance companies by section 201 (d) See § 39.201-8.

§ 39.207-6 *Amortization of premium and accrual of discount.* Section 207 (d) makes provision for the appropriate amortization of premium and the appropriate accrual of discount, attributable to the taxable year, on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 207. Such amortization and accrual is the same as that provided for life insurance companies by section 201 (e) and shall be determined in accordance with § 39.201-9, except that in determining the premium and discount of a mutual insurance company subject to the tax imposed by section 207 the basis provided in section 113 shall be used in lieu of the acquisition value.

§ 39.208 *Statutory provisions; insurance companies; net operating losses.*

SEC. 208. *Net operating losses.*

[Repealed by sec. 163 (b) (2), Rev. Act 1942]

SUPPLEMENT H—NONRESIDENT ALIEN INDIVIDUALS

§ 39.211 *Statutory provisions; tax on nonresident alien individuals.*

SEC. 211. *Tax on nonresident alien individuals*—(a) *No United States business or office*—(1) *General rule*—(A) *Imposition of tax.* 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, 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 30 per centum of such amount, except that such rate shall be reduced, in the case of a resident of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, to such rate (not less than 5 per centum) as may be provided by treaty with such country.

(B) *Capital gains of aliens temporarily present in the United States.* In the case of a nonresident alien individual not engaged in trade or business in the United States, there shall be levied, collected, and paid for each taxable year, in addition to the tax imposed by subparagraph (A)—

(i) If he is present in the United States for a period or periods aggregating less than ninety days during such taxable year—a tax of 30 per centum of the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected during his presence in the United States exceed his losses, allocable to sources within the United States, from such sales or exchanges effected during such presence; or

(ii) If he is present in the United States for a period or periods aggregating ninety days or more during such taxable year—a tax of 30 per centum of the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected at any time during such year exceed his losses, allocable to sources within the United States, from such sales or exchanges effected at any time during such year.

For the purposes of this subparagraph, gains and losses shall be taken into account only if, and to the extent that, they would be recognized and taken into account if such individual were engaged in trade or business in the United States, except that such gains and losses shall be computed without regard to the provisions of section 117 (b) and such losses shall be determined without the benefits of the capital loss carry-over provided in section 117 (e).

(C) *Cross reference.* For inclusion in computation of tax of amount specified in shareholder's consent, see section 28.

(2) *Aggregate more than $15,400.* The taxes imposed by paragraph (1) shall not apply to any individual if during the taxable year the sum of—

(A) The aggregate amount received from the sources specified in paragraph (1) (A), plus

(B) The amount, determined in accordance with the provisions of paragraph (1) (B), by which gains from sales or exchanges of capital assets exceed losses from such sales or exchanges,

is more than $15,400.

(3) *Residents of certain countries.* The provisions of paragraph (2) shall not apply to a resident of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, so long as there is in effect with such country a treaty which provides otherwise.

(b) *United States business or office.* A nonresident alien individual engaged in trade or business in the United States 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, through a resident broker, commission agent, or custodian, of transactions in the United States in commodities (if of a kind customarily dealt in on an organized commodity exchange, if the

transaction is of the kind customarily consummated at such place, and if the alien, partnership, or corporation has no office or place of business in the United States at any time during the taxable year through which or by the direction of which such transactions in commodities are effected), or in stocks or securities.

(c) *No United States business or office and gross income of more than $15,400.* A nonresident alien individual not engaged in trade or business within the United States shall be taxable without regard to the provisions of subsection (a) (1) if during the taxable year the sum of the aggregate amount received from the sources specified in subsection (a) (1) (A), plus the amount (determined in accordance with the provisions of subsection (a) (1) (B)) by which gains from sales or exchanges of capital assets exceed losses from such sales or exchanges, is more than $15,400, except that—

(1) The gross income shall include only income from the sources specified in subsection (a) (1) (A) plus any gain (to the extent provided in section 117) from a sale or exchange of a capital asset if such gain would be taken into account were the tax being determined under subsection (a) (1) (B);

(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) (A), except that any loss from the sale or exchange of a capital asset shall be allowed (to the extent provided in section 117 without the benefit of the capital loss carry-over provided in section 117 (e)) if such loss would be taken into account were the tax being determined under subsection (a) (1) (B);

(3) The tax imposed by this chapter (under sections 11 and 12, or under section 117 (c)) shall, in no case, be less than 30 per centum of the sum of—

(A) The aggregate amount received from the sources specified in subsection (a) (1) (A), plus

(B) The amount, determined in accordance with the provisions of subsection (a) (1) (B), by which gains from sales or exchanges of capital assets exceed losses from such sales or exchanges; and

(4) This subsection shall not apply to a resident of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, so long as there is in effect with such country a treaty which provides otherwise.

[Sec. 211 as amended by sec. 4, Rev. Act 1940; secs. 105 and 109, Rev. Act 1941; secs. 106, 160 (d) and (e), and 167, Rev. Act 1942; sec. 213 (a) and (b), Rev. Act 1950]

§ 39.211-1 *Taxation of aliens in general.* For the purposes of chapter 1, 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 § 39.211-7.

§ 39.211-2 *Definition.* (a) A "nonresident alien individual" means an individual—

(1) Whose residence is not within the United States; and

(2) Who is not a citizen of the United States.

The term includes a nonresident alien fiduciary.

(b) 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 abandoned. 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 section, in the absence of exceptional circumstances.

§ 39.211-3 *Alien seamen as residents.* In order to determine whether an alien seaman is a resident within the meaning of chapter 1, 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 § 39.211-4, 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.

§ 39.211-4 *Proof of residence of alien.* (a) 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 chapter 1. 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 before departure for his native country by (i) proof that the alien, at least six months before 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, (ii) proof that the alien, at least six months before the date he so presents himself, has filed Form 1078 or its equivalent, or (iii) 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 (i) proof that the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (ii) proof that the alien has filed Form 1078 or its equivalent, or (iii) 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.

(b) In any case in which an alien seeks to overcome the presumption of nonresidence under paragraph (a) (1) (iii) or (2) (iii) of this section, 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 before the date of execution of the affidavit or affidavits.

§ 39.211-5 *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.

§ 39.211-6 *Duty of employer to determine status of alien employee.* If wages are paid to aliens without withholding the tax, except as permitted in § 39.143-3, 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 §§ 39.211-1 to 39.211-5, inclusive. 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.

§ 39.211-7 *Taxation of nonresident alien individuals*—(a) *In general.* For the purposes of this section and §§ 39.212-1, 39.213-1, 39.214-1, 39.215-1, and 39.217-2, nonresident alien individuals are divided into three classes: (1) Nonresident alien individuals not engaged in trade or business within the United States at any time during the taxable year and deriving in such taxable year an amount of not more than $15,400 in the aggregate which is the gross amount of fixed or determinable annual or periodical income from sources within the United States plus the excess of capital gains over capital losses, determined in accordance with paragraph (b) (2) of this section, from sources within the United States; (2) nonresident alien individuals not engaged in trade or business within the United States at any time during the taxable year and deriving in such taxable year an amount of more than $15,400 in the aggregate which is the gross amount of fixed or determinable annual or periodical income from sources within the United States plus the excess of capital gains over capital losses, determined in accordance with paragraph (b) (2) of this section, 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. But see § 39.220-1 with respect to alien individuals who are bona fide residents of Puerto Rico during the entire taxable year.

(b) *No United States business; general rule*—(1) *Fixed or determinable annual or periodical income.* (i) A nonresident alien individual within class (1) referred to in paragraph (a) of this section, is liable to the tax upon the aggregate amount received from sources within the United States, determined under the provisions of section 119, which consists of fixed or determinable annual or periodical gains, profits, and income and the excess of capital gains over capital losses, determined in accordance with subparagraph (2) of this paragraph. 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 Internal Revenue Code 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 § 39.143-2.

(ii) 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 at any time during the taxable year and deriving in the taxable year not more than $15,400 gross amount of fixed or determinable annual or periodical income from sources within the United States is taxable at the rate of 30 percent as to such income received, except that such rate shall be reduced as may be provided by treaty with any country. The excess of capital gains over capital losses, determined in accordance with subparagraph (2) of this paragraph, is also subject to tax and is to be aggregated with such fixed or determinable annual or periodical income in determining such $15,400.

(2) *Capital gains and losses.* (i) A nonresident alien individual within class (1) referred to in paragraph (a) of this section, is liable to a tax of 30 percent upon the excess of capital gains derived from sources within the United States over capital losses allocable to such sources, determined under the provisions of section 119 and in accordance with the provisions of this subparagraph. This tax is in addition to the tax imposed, as indicated in subparagraph (1) of this paragraph, upon the gross amount of fixed or determinable annual or periodical income derived from sources within the United States by such nonresident alien individual. However, section 211 (a) (1) (B) and this subparagraph do not apply to any capital gain which is exempt from tax under a treaty or convention to which the United States is a party.

(ii) If he has been present in the United States for a period or periods aggregating less than 90 days during the taxable year, a nonresident alien individual not engaged in trade or business within the United States at any time during such taxable year is liable to a tax of 30 percent upon the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected during his presence in the United States exceed his losses, allocable to sources within the United States, from such sales or exchanges effected during such presence. Gains or losses from sales or exchanges of capital assets effected during such taxable year at times other than during such presence in the United States are not to be taken into account.

(iii) If he has been present in the United States for a period or periods aggregating 90 days or more during the taxable year, a nonresident alien individual not engaged in trade or business within the United States at any time during such taxable year is liable to a tax of 30 percent upon the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected at any time during such year exceed his losses, allocable to sources within the United States, from such sales or exchanges effected at any time during such year. Gains or losses from sales or exchanges effected at any time during such taxable year are to be taken into account even though such alien individual is not present in the United States at the time such sales or exchanges are effected.

(iv) In computing the total period of presence in the United States for a taxable year, all separate periods of presence in the United States during the taxable year are to be aggregated.

(v) For the purpose of the computation of the excess of capital gains over capital losses subject to tax, gains and losses shall be taken into account only if, and to the extent that, they would be recognized and taken into account if the nonresident alien individual were engaged in trade or business within the United States, except that such gains or losses shall be computed without regard to the provisions of section 117 (b) and that such losses shall be determined without the benefit of the provision under section 117 (e) for the capital loss carry-over. The excess, if any, of capital losses over capital gains in such computation is of no tax significance, since such losses shall be allowed only to the extent of such gains.

(vi) Where sales or exchanges of capital assets (effected either during the period or periods of presence in the United States when such period or periods aggregate less than 90 days during the taxable year, or at any time during the taxable year when such period or periods aggregate 90 days or more during such taxable year) result only in capital losses allocable to United States sources, there being no gains derived from United States sources from such sales or exchanges, such losses shall not to any extent be allowed as a deduction from the fixed or determinable annual or periodical income derived by such nonresident alien individual from United States sources during such taxable year.

(c) *No United States business; aggregate more than $15,400.* A nonresident alien individual within class (2), referred to in paragraph (a) of this section, is, in accordance with the provisions of section 211 (c), subject to tax under sections 11 and 12, or in the alternative under section 117 (c) upon the amount which is the sum of the aggregate of his fixed or determinable annual or periodical income specified in section 211 (a) (1) (A), determined under the provisions of section 119, plus any gain from a sale or exchange of a capital asset if such gain would be taken into account were the tax being determined under section 211 (a) (1) (B) and under paragraph (b) (2) of this section, minus (1) the deductions properly allocable to such fixed or determinable annual or periodical income, (2) the so-called "charitable contributions" deduction provided in section 213 (c), and (3) any loss (without the benefit of the capital loss carry-over provided in section 117 (e)) from the sale or exchange of a capital asset if such loss would be taken into account were the tax being determined under section 211 (a) (1) (B) and under paragraph (b) (2) of this section. 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 com-

puted under sections 11 and 12, or in the alternative under section 117 (c), shall in no case be less than 30 percent of the amount which is the sum of the aggregate of the gross amounts of fixed or determinable annual or periodical income from sources within the United States plus the amount, determined in accordance with the provisions of section 211 (a) (1) (B) and of paragraph (b) (2) of this section, by which gains from sales or exchanges of capital assets exceed losses from such sales or exchanges.

(d) *United States business.* A nonresident alien individual within class (3), referred to in paragraph (a) of this section, is not taxable at the rate of 30 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 and surtax under sections 11 and 12.

(e) *What constitutes engaging in trade or business.* As used in sections 119, 143, 144, 211, 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 § 39.212-1. As used in section 211 (b) the term "commodities" means only goods of a kind customarily dealt in on an organized commodity exchange, such as a grain futures or a cotton futures market, and does not include merchandise in the ordinary channels of commerce. 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 merely because the trustee is engaged in trade or business in the United States.

§ 39.212 *Statutory provisions; nonresident alien individuals; gross income.*

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) *Exclusions.* The following items shall not be included in gross income of a nonresident alien individual and shall be exempt from taxation under this chapter:

(1) *Ships under foreign flag.* Earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equilavent exemption to citizens of the United States and to corporations organized in the United States;

(2) *Aircraft of foreign registry.* Earnings derived from the operation of aircraft registered 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.

[Sec. 212 as amended by sec. 1 (a), Pub. Law 514 (80th Cong.)]

§ 39.212-1 *Gross income of nonresident alien individuals*—(a) *In general.* (1) In general, in the case of nonresident alien individuals "gross income" means only the gross income from sources within the United States. See section 119 and the regulations thereunder. 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 §§ 39.211-2 to 39.211-6, inclusive.

(2) 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 before 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 before the close of the taxable year.

(b) *No United States business.* The gross income of a nonresident alien individual not engaged in trade or business within the United States 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 and any gain from the sale or exchange of a capital asset to the extent required to be included in gross income under the provisions of section 211 (a) (1) (B) or section 211 (c).

(c) *United States business.* 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 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).

(d) *What constitutes engaging in trade or business within United States.* (1) 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 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 or of international organizations, see section 116 (h)

(2) 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, 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. As used in section 211 (b), the term "commodities" means only goods of a kind customarily dealt in on an organized commodity exchange, such as a grain futures or a cotton futures market, and does not include merchandise in the ordinary channels of commerce.

§ 39.212-2 *Exclusion of earnings of foreign ships or aircraft from gross income*—(a) *Ships under foreign flag.* 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 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 paragraph. A nonresident alien individual not engaged in trade or business within the United States 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 requirement of the Internal Revenue Code.

(b) *Aircraft of foreign registry.* 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 as consists of earnings derived from the operation of aircraft registered 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 aircraft registered under the laws of the United States are considered as granting an equivalent exemption within the meaning of this paragraph. A nonresident alien individual not engaged in trade or business within the United States 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 aircraft, whether or not the foreign country under the laws of which such aircraft are registered meets the equivalent exemption requirement of the Internal Revenue Code.

§ 39.213 *Statutory provisions; nonresident alien individuals; deductions.*

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 chapter.

(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.

(d) *Standard deduction.* The standard deduction provided in section 23 (aa) shall not be allowed.

[Sec. 213 as amended by sec. 9 (d), Individual Income Tax Act 1944]

§ 39.213-1 *Deductions allowed nonresident alien individuals*—(a) *No United States business*—(1) *General rule.* In general, a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year is not allowed any deductions, the tax being imposed upon the amount of gross income received, except that losses allocable to sources within the United States from sales or exchanges of capital assets shall be allowed in accordance with the provisions of paragraph (b) (2) of § 39.211-7 to the extent of gains, derived from sources therein, from such sales or exchanges.

(2) *Aggregate more than $15,400.* A nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year and deriving for such year more than $15,400 in the aggregate which is the gross amount of fixed or determinable annual or periodical income from sources within the United States plus the excess of capital gains over capital losses (determined in accordance with the provisions of paragraph (b) (2) of § 39.-211-7) from sources within the United States is allowed for such year (i) such deductions as are properly allocable to such fixed or determinable annual or periodical income and (ii) losses from sales or exchanges of capital assets, allocable to sources within the United States, to the extent and in the manner provided in paragraph (c) of § 39.211-7. 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) subject to the limitations provided in section 23 (o)

(b) *United States business.* (1) 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, the deductions allowed by section 23 (other than the optional standard deduction for individuals allowed by section 23 (aa)) 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, (i) 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; (ii) 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 (iii) 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) subject to the limitation provided in section 23 (o)

(2) Losses embraced under subdivision (ii) of subparagraph (1) of this paragraph 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 § 39.119 (e)-1. Losses embraced under subdivision (i) of subparagraph (1) of this paragraph are deductible in full (as provided in § 39.119 (a)-7 or § 39.119 (b)-1) 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 § 39.119 (e)-1 when the profit from the transaction, if it had resulted in profit, would have been taxable only in part.

§ 39.214 *Statutory provisions; nonresident alien individuals; credits against net income.*

SEC. 214. *Credits against net income.* In the case of a nonresident alien individual who is not a resident of a contiguous country, only one exemption under section 25 (b) shall be allowed.

[Sec. 214 as amended by sec. 6 (b), Rev. Act 1940; sec. 111 (b), Rev. Act 1941; sec. 131 (a) (2), Rev. Act 1942; sec. 10 (f), Individual Income Tax Act 1944; sec. 102 (b) (7), Rev. Act 1945]

§ 39.214-1 *Credits to nonresident alien individuals*—(a) *No United States business*—(1) *General rule.* In general, a nonresident alien individual not engaged in trade or business in the United States 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 $15,400.* In the case of a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year and deriving in such year gross income described in section 211 (a) (1) from sources within the United States of more than $15,400, the credits allowed are those applicable in the case of nonresident alien individuals engaged in trade or business within the United States.

(b) *United States business.* In the case of a nonresident alien individual (except a resident of Canada or Mexico) who at any time during the taxable year was engaged in trade or business within the United States, only one exemption under section 25 (b) for both normal-tax and surtax purposes shall be allowed. In the case of a resident of Canada or Mexico, the same exemptions under section 25 (b) for both normal tax and surtax,

as in the case of a citizen of the United States, shall apply.

§ 39.215 *Statutory provisions; nonresident alien individuals; allowance of deductions and credits.*

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 chapter 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 chapter; 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 exemptions under section 25 (b) 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.

[Sec. 215 as amended by sec. 10 (g), Individual Income Tax Act 1944; sec. 102 (b) (8), Rev. Act 1945]

§ 39.215-1 *Allowance of deductions and credits to nonresident alien individuals*—(a) *No United States business*—(1) *General rule.* In general, a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year is not entitled to any allowance of deductions (except as provided in paragraph (b) (2) of § 39.211-7) or credits even though he may file a return of income.

(2) *Aggregate more than $15,400.* Unless a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year and having, for such year from sources within the United States, income described in section 211 (a) (1) in a gross amount of more than $15,400 shall file or cause to be filed with the district director of internal revenue a true and accurate return of his total income described in section 211 (a) (1) from sources within the United States as required by paragraph (a) (2) of § 39.217-2, the tax shall be collected on the basis of gross amount of such income described in section 211 (a) (1) Where such nonresident alien has various sources of income described in section 211 (a) (1) 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 income described in section 211 (a) (1) from United States sources is in excess of $15,400 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 income described in section 211 (a) (1) 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 1040NB-a of all income described in section 211 (a) (1) from sources within the United States. Such return shall contain or be verified by a written declaration that it is made under the penalties of perjury. As to the duty of the representative or agent of such alien to file the return and pay the tax, see paragraph (b) (2) of § 39.217-2, which is hereby made equally applicable in the case of a nonresident alien individual coming within the provisions of this subparagraph.

(b) *United States business.* Unless a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States shall file, or cause to be filed, with the district director of internal revenue, a true and accurate return of his total income from sources within the United States, as required by paragraph (b) (1) of § 39.217-2, 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.

§ 39.216-217 *Statutory provisions; nonresident alien individuals; credits against tax; returns.*

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. A nonresident alien individual shall be allowed as a credit against his tax the amount required by section 396 to be paid by the personal service corporation of which he is a shareholder with respect to his tax liability under Supplement S.

[Sec. 216 as amended by sec. 504, Second Rev. Act 1940]

SEC. 217. *Returns*—(a) *Requirement.* In the case of a nonresident alien individual with respect to whose wages, as defined in section 1621 (a), withholding under Subchapter D of Chapter 9 is not made applicable, 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) (1) (A) may be exempted from the requirement of filing returns of such tax.

[Sec. 217 as amended by sec. 5 (c) (1), Current Tax Payment Act 1943; sec. 213 (c), Rev. Act 1950]

§ 39.217-1 *Time and place for filing returns of nonresident alien individuals.* (a) In the case of a nonresident alien individual who for the taxable year does not have wages subject to withholding at the source under section 1622, the return must be made on or before the fifteenth day of the sixth full calendar month following the close of the taxable year. In the case of any return for a fractional part of a year, the Commissioner may, upon a showing by the taxpayer of unusual circumstances, prescribe a later time for the filing of the return, but such time shall not be later than the fifteenth day of the eighteenth full calendar month ending after the beginning of the fractional part of the year. For certain cases in which the time for filing the return is postponed, see section 3804. The return must be filed with the district director of internal revenue for the internal revenue 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 District Director of Internal Revenue at Baltimore, Maryland. 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 § 39.217-2.

(b) In the case of nonresident alien individuals who have wages subject to withholding under section 1622, the general rule provided in paragraph (a) of this section with respect to the filing of the return has no application. Such aliens are required to file their returns and to pay the tax at the time prescribed generally for United States citizens and residents. As to the time of filing the return in the case of United States citizens and residents, see section 53 and § 39.53-1.

§ 39.217-2 *Return of income*—(a) *No United States business*—(1) *General rule.* If the tax liability of a nonresident alien individual not engaged in trade or business within the United States 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 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 income described in section 211 (a) (1) 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 $15,400.* A nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year, and deriving in such year more than $15,400 gross amount of income described in section 211 (a) (1) from sources with-

in the United States, shall make or have made a full and accurate return on Form 1040NB-a of all his income described in section 211 (a) (1) from sources within the United States. Except as to gains from transactions described in section 211 (a) (1) (B) 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) (2) of this section, which is hereby made equally applicable in the case of a nonresident alien coming within the provisions of this subparagraph.

(b) *United States business.* (1) If a nonresident alien individual at any time within the taxable year is engaged in trade or business within the United States, 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 $600 during the taxable year.

(2) 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 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 § 39.51-2. 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.

(c) *Refund based on return.* Where upon filing a return of income it appears that such a nonresident alien is not liable for tax, but nevertheless a tax shall have been withheld at the source, there should, in order to obtain a refund on the basis of the showing made by the return, 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 § 39.143-4.

(d) *Verification of returns.* A return on Form 1040B, Form 1040NB, or Form 1040NB-a shall contain or be verified by a written declaration that it is made under the penalties of perjury.

(e) *Supplement U tax.* For returns with respect to the tax imposed by section 421 (a) upon Supplement U net income, see § 39.421-3.

§ 39.218 *Statutory provisions; nonresident alien individuals; payment of tax.*

SEC. 218. *Payment of tax*—(a) *Time of payment.* In the case of a nonresident alien individual with respect to whose wages, as defined in section 1621 (a), withholding under Subchapter D of Chapter 9 is not made applicable, the total amount of tax imposed by this chapter 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.

[Sec. 218 as amended by sec. 5 (e) (2), Current Tax Payment Act 1943]

§ 39.218-1 *Date on which tax shall be paid by nonresident alien individual.* (a) In the case of a nonresident alien individual who, for the taxable year, does not have wages subject to withholding under section 1622, the tax shall be paid on or before the date prescribed by section 217 and § 39.217-1 for filing of the return, without regard to any extension of time granted for the filing of the return under authority of section 53. As to payment of the tax in installments, see § 39.56-1. For provisions relating to certain cases in which the time for payment of income tax is postponed by reason of an individual serving in or in support of the military or naval forces of the United States in combat zone, see section 3804.

(b) In the case of a nonresident alien individual who for the taxable year has wages subject to withholding at the source under the provisions of section 1622, the tax shall be paid at the time provided in the case of United States citizens and residents. See § 39.56-1.

§ 39.219 *Statutory provisions; nonresident alien individuals; partnerships.*

SEC. 219. *Partnerships.* For the purpose of this chapter, 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.

[Sec. 219 as amended by sec. 160 (f), Rev. Act 1942]

§ 39.219-1 *Partnerships.* Whether a nonresident alien individual who is a member of a partnership is taxable under the provisions of section 211 (a) or (c) or under the provisions of 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 is subject to the provisions of section 211 (a) or (c) as the case may be, depending on whether, in the taxable year, he derives income described in section 211 (a) (1) from sources within the United States of more than $15,400, if he is not otherwise engaged in trade or business within the United States. 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 is considered as being engaged in trade or business within the United States and is therefore taxable under section 211 (b) For definition of what the term "partnership" includes, see section 3797 (a) (2) The test of whether a partnership is engaged in trade or business within the United States is the same as in the case of a nonresident alien individual. See § 39.211-7.

§ 39.220 *Statutory provisions; nonresident alien individuals; alien residents of Puerto Rico.*

SEC. 220. *Alien residents of Puerto Rico*—(a) *No application to certain alien residents of Puerto Rico.* The provisions of this supplement shall have no application to an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, and such alien shall be subject to the taxes imposed by sections 11 and 12.

(b) *Cross reference.* For exclusion from gross income of income derived from sources within Puerto Rico, see section 116 (l) (1).

[Sec. 220 as added by sec. 221 (d), Rev. Act 1950]

§ 39.220-1 *Alien residents of Puerto Rico.* The provisions of Supplement H, relating to the taxation of nonresident alien individuals, do not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, irrespective of whether he has engaged in trade or business within the United States during the taxable year. The income of such alien individual from sources both within and without the United States is subject to the normal tax and the surtax imposed by sections 11 and 12, respectively, except that under the provisions of section 116 (l) income derived from sources within Puerto Rico (other than amounts received for services performed as an employee of the United States or any agency thereof) is excluded from gross income. For rules respecting filing of returns and payment of tax, see sections 51, 53, 56, 58, and 59 and the regulations thereunder.

§ 39.221 *Statutory provisions; nonresident alien individuals; certain foreign exempt organizations.*

SEC. 221. *Foreign educational, charitable and certain other exempt organizations.* For special provisions relating to foreign educational, charitable and other exempt trusts, see section 421 (d).

[Sec. 221 as added by sec. 301 (c) (5), Rev. Act 1950]

SUPPLEMENT I—FOREIGN CORPORATIONS

§ 39.231 *Statutory provisions; tax on foreign corporations.*

SEC. 231. *Tax on foreign corporations*—(a) *Nonresident corporations*—(1) *Imposition of tax.* 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, 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 30 per centum of such amount, except that in the case of corporations organized under the laws of any country in North, Central, or South America, or in the West Indies, or of Newfoundland such rate 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.

(2) *Cross reference.* 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 shall be taxable as provided in section 13 and section 15.

(c) *Gross income.* In the case of a foreign corporation gross income includes only the gross income from sources within the United States.

(d) *Exclusions.* The following items shall not be included in gross income of a foreign corporation and shall be exempt from taxation under this chapter:

(1) *Ships under foreign flag.* 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;

(2) *Aircraft of foreign registry.* Earnings derived from the operation of aircraft registered 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.

[Sec. 231 as amended by sec. 206, Rev. Act 1939; sec. 3 (c), Rev. Act 1940; secs. 104 (d), 106, and 109 (a), Rev. Act 1941; secs. 107 and 160 (d) and (e), Rev. Act 1942; sec. 1 (b), Pub. Law 514 (80th Cong.); sec. 121 (g) (5), Rev. Act 1950]

§ 39.231-1 *Taxation of foreign corporations*—(a) *General.* For the purposes of this section and §§ 39.231-2, 39.232-1, 39.235-1, 39.235-2, and 39.236-1, foreign corporations are divided into two classes: (1) Foreign corporations not engaged in trade or business within the United States at any time within the taxable year, referred to in the regulations as nonresident foreign corporations (see § 39.3797-8) and (2) foreign corporations which at any time within the taxable year are engaged in trade or business within the United States, referred to in the regulations as resident foreign corporations (see § 39.3797-8)

(b) *Nonresident foreign corporations.* (1) 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 Internal Revenue Code as interest (except interest on deposits with persons carrying on the banking business) dividends, rents, salaries, wages, premiums, annuities, compensations, renumerations, 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 § 39.143-2.

(2) The fixed or determinable annual or periodical income from sources within the United States, including royalties, of a nonresident foreign corporation is taxable at the rate of 30 percent. In the case of dividends received by a nonresident foreign corporation, the rate shall be reduced to such rate as may be provided by treaty with any country.

(c) *Resident foreign corporations.* (1) A resident foreign corporation is not taxable upon the items of fixed or determinable annual or periodical income enumerated in section 231 (a) at the rate specified in that section. A resident foreign corporation is, under section 13, liable to a tax of 30 percent (25 percent for taxable years beginning after March 31, 1954) of its normal-tax net income. The normal-tax net income of a resident foreign corporation 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 provided in section 26 (a) and (b)

(2) A resident foreign corporation is, under section 15, also liable to a tax of 22 percent of the amount of its corporation surtax net income in excess of $25,000. See, however, § 39.15-2, as to the circumstances under which the $25,000 exemption from surtax for certain taxable years may be disallowed in whole or in part. The corporation surtax net income of a resident foreign corporation 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 credit provided in section 26 (b) which credit is limited in amount to 85 percent of its adjusted net income from sources within the United States computed without regard to the deduction for net operating loss provided in section 23 (s)

(3) For taxable years beginning before April 1, 1954, and ending after March 31, 1954, see § 39.108-2.

(d) *Meaning of terms used.* As used in sections 119, 143, 144, 211, 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. 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. The term "commodities," as used in section 211 (b) means only goods of a kind customarily dealt in on an organized commodity exchange, such as a grain futures or a cotton futures market, and does not include merchandise in the ordinary channels of commerce.

§ 39.231-2 *Gross income of foreign corporations*—(a) *In general.* 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 (a) (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 §§ 39.119 (a)-1 to 39.119(e)-4, inclusive. 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 3797 (a) (3) and (5). As to foreign life insurance companies, see § 39.201-2. As to foreign corporations formed or availed of to avoid surtax, see § 39.102-4. As to personal holding companies organized under the laws of foreign countries, see § 39.505-1. As to foreign personal holding companies, see sections 331 to 340, inclusive, and §§ 39.331-1 to 39.339-3, inclusive.

(b) *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.

(c) *Resident foreign corporations.* (1) 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).

(2) 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.

(3) 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, being a resident foreign corporation, is taxable upon all income derived from sources

within the United States, including the profits realized from such transactions.

§ 39.231-3 *Exclusion of earnings of foreign ships or aircraft from gross income*—(a) *Nonresident foreign corporations.* 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 or aircraft, whether or not the foreign country under the laws of which such ships are documented or aircraft registered meets the equivalent exemption requirements of the statute.

(b) *Resident foreign corporations.* 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 or aircraft registered under the laws of a foreign country to the same extent as provided in § 39.212-2 with respect to nonresident alien individuals.

§ 39.232 *Statutory provisions; foreign corporations; deductions.*

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 the 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.

§ 39.232-1 *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 § 39.231-1.

(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 § 39.201-2. As to foreign corporations formed or availed of to avoid surtax, see § 39.102-4. As to personal holding companies organized under the laws of foreign countries, see § 39.505-1. As to foreign personal holding companies, see sections 331 to 340, inclusive, and §§ 39.331-1 to 39.339-3, inclusive.

§ 39.233 *Statutory provisions; foreign corporations; allowance of deductions and credits.*

SEC. 233. *Allowance of deductions and credits.* A foreign corporation shall receive the benefit of the deductions and credits allowed to it in this chapter 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 chapter; including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits.

§ 39.233-1 *Allowance of deductions and credits*—(a) *Resident foreign corporations.* 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 district director of internal revenue 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)

(b) *Nonresident foreign corporations.* 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.

§ 39.234-235 *Statutory provisions; foreign corporations; credits against tax; returns.*

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. A foreign corporation shall be allowed as a credit against its tax the amount required by section 396 to be paid by the personal service corporation of which it is a shareholder with respect to its tax liability under Supplement S.

[Sec. 234 as amended by sec. 505, Second Rev. Act. 1940]

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.

§ 39.235-1 *Time and place for filing returns of foreign corporations*—(a) *Nonresident foreign corporations.* The return in the case of a nonresident foreign corporation shall be made on or before the fifteenth day of the sixth full calendar month following the close of the taxable year. In the case of any return for a fractional part of a year the Commissioner may, upon a showing by the taxpayer of unusual circumstances, prescribe a later time for the filing of the return, but such time shall not be later than the fifteenth day of the eighteenth full calendar month ending after the beginning of the fractional part of the year. 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 District Director of Internal Revenue, Baltimore, Maryland. 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 § 39.235-2.

(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 fifteenth day of the third month following the close of the fiscal year, or on or before the fifteenth day of March if on the basis of the calendar year. See section 53 (a) (1) If the return is for a fractional part of a year, it shall be filed at the time prescribed in § 39.53-1. The return must be filed with the district director of internal revenue for the internal revenue 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.

§ 39.235-2 *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.

(c) *Supplement U tax.* For returns with respect to the tax imposed by section 421 (a) upon Supplement U net income, see § 39.421-3.

§ 39.236 *Statutory provisions; foreign corporations; payment of tax.*

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 chapter 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.

§ 39.236-1 *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 chapter 1 shall be paid on or before the date prescribed by section 235 and § 39.235-1 for filing of the return, without regard to any extension of time granted for the filing of the return under authority of section 53. As to payment of the tax in installments, see § 39.56-1.

(b) *Resident foreign corporations.* In the case of a resident foreign corporation, the total amount of tax imposed by chapter 1 shall be paid, in lieu of the time prescribed in section 236 (a) on the fifteenth 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 fifteenth day of the third month following the close of the fiscal year. If the return is made for a fractional part of a year, the tax shall be paid at the time prescribed in § 39.56-1. As to payment of the tax in installments, see § 39.56-1.

§ 39.237—238 *Statutory provisions; foreign corporations; insurance companies; certain exempt organizations.*

SEC. 237. *Foreign insurance companies.* For special provisions relating to foreign insurance companies, see Supplement G.

SEC. 238. *Foreign educational, charitable and certain other exempt organizations.* For special provisions, relating to foreign educational, charitable and certain other exempt organizations, see section 421 (d).

[Sec. 238 as added by sec. 301 (c) (6), Rev. Act 1950]

SUPPLEMENT J—POSSESSIONS OF THE UNITED STATES

§ 39.251 (a) *Statutory provisions; income from sources within possessions of the United States; general rule.*

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.

§ 39.251 (a)-1 *Citizens of the United States and domestic corporations deriving income from sources within a possession of the United States.* (a) 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. The salary or other compensation paid for services preformed by a citizen of the United States as an employee of the United States or any agency thereof shall, for the purposes of section 251 and this section, be deemed to be derived from sources within 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.

(b) 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 Internal Revenue Code, 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 that (1) he is a bona fide resident of a foreign country or countries during the entire taxable year, and (2) he 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 116 (a) (3).

(c) In the case of a husband and wife making a joint return, the term "gross income," as used in this section, means the combined gross income of the spouses.

(d) For a determination of income from sources within the United States, see sections 119 and 251 (j) A citizen entitled to the benefits of section 251 is required to file with his individual return Form 1040 the schedule on Form 1040E. 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 1040E.

(e) This section may be illustrated by the following example: On July 1, 1952, A, who is a citizen of the United States, went to a possession of the United States 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 1952 of some real estate located in such possession and not connected with his trade or business. In the first six months of 1952 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 1952. Inasmuch as for the applicable part (July 1, 1952, to December 31, 1952) of the 3-year period immediately preceding the close of the taxable year (the calendar year 1952) 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 1952 only the gross income derived by him from sources within the United States ($16,000 from the rental property located in the United States).

§ 39.251 (b) *Statutory provisions; income from sources within possessions of the United States; amounts received in the United States.*

SEC. 251. *Income from sources within possessions of United States.* * * *

(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.

§ 39.251 (b)-1 *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 in-

stance, if in the example set forth in paragraph (e) of § 39.251 (a)-1, the taxpayer during the latter part of 1952 returned to the United States for a few weeks and while there received the proceeds resulting from the sale of the real estate located in the possession, 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.

§ 39.251 (c) *Statutory provisions; income from sources within possessions of the United States; tax of corporations.*

SEC. 251. *Income from sources within possessions of United States.* * * *

(c) *Tax in case of corporations*—(1) *Corporation tax.* A domestic corporation entitled to the benefits of this section shall be subject to tax under section 13 or section 14 (b), and under section 15.

(2) *Cross reference.* For inclusion in computation of tax of amount specified in shareholder's consent, see section 28.

[Sec. 251 (c) as amended by sec. 207, Rev. Act 1939; sec. 104 (e), Rev. Act 1940]

§ 39.251 (c)-1 *Tax in case of corporations.* A domestic corporation entitled to the benefits of section 251 is, under section 251 (c) (1) subject to the normal tax on corporations imposed by section 13 and the surtax on corporations imposed by section 15.

§ 39.251 (d) *Statutory provisions; income from sources within possessions of the United States; definition.*

SEC. 251. *Income from sources within possessions of United States.* * * *

(d) *Definition.* As used in this section the term "possession of the United States" does not include the Virgin Islands of the United States, and such term when used with respect to citizens of the United States does not include Puerto Rico.

[Sec. 251 (d) as amended by sec. 221 (a), Rev. Act 1950]

§ 39.251 (d)-1 *Definitions.* (a) As used in section 251 and the regulations thereunder, the term "United States" includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.

(b) As used in sections 251 and 252 and §§ 39.251 (a)-1 and 39.252-1, the term "possession of the United States" includes the Panama Canal Zone, Guam, American Samoa, Wake, and the Midway Islands. The term does not include the Virgin Islands, nor does it include Puerto Rico when used with respect to citizens of the United States.

§ 39.251 (e) *Statutory provisions; income from sources within possessions of the United States; deductions.*

SEC. 251. *Income from sources within possessions of 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.

(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.

[Sec. 251 (e) as amended by sec. 160 (d), Rev. Act 1942]

§ 39.251 (e)-1 *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 (other than the optional standard deduction for individuals allowed by section 23 (aa)) are allowed only if and to the extent that they are connected with income from sources within the United States. The provisions of § 39.213-1 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, of the deductions provided in section 23 (e) (2) and (3) 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 § 39.213-1 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.

§ 39.251 (f)-(g) *Statutory provisions; income from sources within possessions of the United States; credits against net income; allowance of deductions and credits.*

SEC. 251. *Income from sources within possessions of United States.* * * *

(f) *Credits against net income.* A citizen of the United States entitled to the benefits of this section shall be allowed only one exemption under section 25 (b).

[Sec. 251 (f) as amended by sec. 6 (c), Rev. Act 1940; sec. 111 (c), Rev. Act 1941; sec. 131 (a) (3), Rev. Act 1942; sec. 10 (h), Individual Income Tax Act 1944; sec. 102 (b) (9), Rev. Act 1945]

(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 chapter 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 chapter; including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits.

§ 39.251 (g)-1 *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 district director of internal revenue 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 citizen 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.

§ 39.251(h)-(j) *Statutory provisions; income from sources within possessions of the United States; credits against tax; prisoners of war and internees; employees of the United States.*

SEC. 251. *Income from sources within possessions of United States.* * * *

(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) *Prisoners of war and internees.* In the case of a citizen of the United States taken as a prisoner of war while serving within a possession of the United States as a member of the military or naval forces of the United States, and in the case of a citizen interned by the enemy while serving as an employee within a possession of the United States—

(1) If such citizen was confined in any place not within a possession of the United States, such place of confinement shall, for the purposes of this section, be considered as within a possession of the United States; and

(2) Any compensation received within the United States by such citizen attributable to the period of time during which such citizen was a prisoner of war or interned by the enemy shall, for the purposes of subsection (b), be considered as compensation received outside the United States.

[Sec. 251 (i) as added by Pub. Law 310 (80th Cong.)]

(j) *Employees of United States.* For the purposes of this section, amounts paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall be deemed to be derived from sources within the United States.

[Sec. 251 (j) as added by sec. 220, Rev. Act 1950]

§ 39.252 *Statutory provisions; taxation of citizens of possessions of the United States.*

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 chapter 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. This subsection shall have no

application in the case of a citizen of Puerto Rico.

(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, c. 44, 42 Stat. 123 (U. S. C., Title 48, § 1397), relating to the imposition of income taxes in the Virgin Islands of the United States.

[Sec. 252 as amended by sec. 221 (b), Rev. Act 1950]

§ 39.252–1 *Status of citizens of United States possession.* (a) (1) A citizen of a possession of the United States (except the Virgin Islands or Puerto Rico) 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 to 219, inclusive. 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.

(2) For the purpose of this section citizens of the possessions of the United States who are not otherwise citizens of the United States are divided into two classes: (i) 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 (ii) 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. The provisions of §§ 39.211–7 to 39.219–1, inclusive, applicable to nonresident alien individuals not engaged in trade or business within the United States, are applicable to the citizens of possessions falling within the first class, while the provisions of such sections applicable to nonresident alien individuals who at any time within the taxable year are engaged in trade or business within the United States are applicable to citizens of possessions falling within the second class.

(b) The provisions of section 252 (a) and this section shall have no application in the case of a citizen of Puerto Rico.

(c) The act of July 12, 1921 (48 U. S. C. 1397) 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 income tax provisions of the Internal Revenue Code.

SUPPLEMENT K—CHINA TRADE ACT CORPORATIONS

§ 39.261 *Statutory provisions; tax of China Trade Act corporations.*

SEC. 261. *Taxation in general*—(a) *Corporation tax.* A corporation organized under the China Trade Act, 1922 (42 Stat. 849; U. S. C., 1934 ed., title 15, ch. 4), shall be subject to tax under section 13 or section 14 (b), and under section 15.

(b) *Cross reference.* For inclusion in computation of tax of amount specified in shareholder's consent, see section 28.

[Sec. 261 as amended by sec. 203, Rev. Act 1939; sec. 104 (f) (1), Rev. Act 1941]

§ 39.261–1 *Tax on China Trade Act corporations.* A China Trade Act corporation is, under section 261 (a), subject to the normal tax on corporations imposed by section 13 and the surtax on corporations imposed by section 15.

§ 39.262 *Statutory provisions; China Trade Act corporations; credit against net income.*

SEC. 262. *Credit against net income*—(a) *Allowance of credit.* For the purpose only of the taxes imposed by sections 13, 14, 15, and 600 of this title 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 13, 14, or 15 (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 600 (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 13, 14, or 15.

(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 methods 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. 262 as amended by sec. 210 (c), Rev. Act 1939; sec. 104 (f) (2), Rev. Act 1941]

§ 39.262–1 *Income and deductions of China Trade Act corporations.* The items of gross income to be included in the return of a China Trade Act corporation and the deductions allowable are the same as in the case of other domestic corporations.

§ 39.262–2 *Credits allowed China Trade Act corporations.* (a) 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 13 and 15. 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 sections 13 and 15 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. 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.

(b) The application of this section may be illustrated by the following example:

Example. (1) The A Company, a China Trade Act corporation, has a net income for the calendar year 1952 of $200,000 and receives no dividends from domestic corporations. All of its stock on December 31, 1952, 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. It distributes a special dividend amounting to $100,000 on February 15, 1953, which is certified by the Secretary of Commerce as provided in section 262 (b). For the purpose of the tax imposed by sections 13 and 15, 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:

(2) *First computation; without allowing the special credit against net income.*

Net income subject to tax	$200,000
Normal-tax net income	200,000
Normal tax (section 13)	60,000
Surtax net income	200,000
Surtax (section 15)	33,500
Total income tax	93,500

(3) *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 sections 13 and 15	None

(4) Since the special dividend ($100,000) exceeds the diminution of the tax ($98,500) 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 1952.

§ 39.262-3 *Meaning of terms used in connection with China Trade Act corporations.* (a) A China Trade Act corporation is one organized under the provisions of the China Trade Act, 1922 (15 U. S. C., c. 4)

(b) 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 Hong Kong, and (3) the Province of Macao.

(c) The term "special dividend" means the amount which, during the year ending on the date fixed by law for the filing of the corporation's return, is distributed as a 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. The time fixed by law for filing the return includes the period of any extension of time granted under rules and regulations prescribed by the Commissioner with the approval of the Secretary. 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.

(d) 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.

(e) "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.

§ 39.262-4 *Withholding by a China Trade Act corporation.* Dividends distributed by a China Trade Act corporation which are treated as income from sources within the United States under the provisions of section 119 are subject to withholding at the rate of 30 percent when paid to persons (other than residents of China) who are (a) nonresident aliens, (b) nonresident partnerships composed in whole or in part of nonresident aliens, or (c) nonresident foreign corporations. The 30 percent rate of withholding specified in this section with respect to dividends shall be reduced to such rate as may be provided by treaty with any country.

§ 39.263-265 *Statutory provisions; China Trade Act corporations; credits against tax; affiliation; income of shareholders.*

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.* * * * [Repealed by sec. 159 (e), Rev. Act 1942.]

SEC. 265. *Income of shareholders.* For exclusion of dividends from gross income, see section 116.

SUPPLEMENT L—ASSESSMENT AND COLLECTION OF DEFICIENCIES

§ 39.271 *Statutory provisions; assessment and collection of deficiencies; definition of deficiency.*

SEC. 271. *Definition of deficiency*—(a) *In general.* As used in this chapter in respect of a tax imposed by this chapter, "deficiency" means the amount by which the tax imposed by this chapter exceeds the excess of—

(1) The sum of (A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over—

(2) The amount of rebates, as defined in subsection (b) (2), made.

(b) *Rules for application of subsection (a).* For the purposes of this section—

(1) The tax imposed by this chapter and the tax shown on the return shall both be determined without regard to payments on account of estimated tax, without regard to the credit under section 35, and without regard to so much of the credit under section 32 as exceeds 2 per centum of the interest on obligations described in section 143 (a);

(2) The term "rebate" means so much of an abatement, credit, refund, or other repayment, as was made on the ground that the tax imposed by this chapter was less than the excess of the amount specified in subsection (a) (1) over the amount of rebates previously made; and

(3) The computation by the collector, pursuant to section 51 (f), of the tax imposed by this chapter shall be considered as having been made by the taxpayer and the tax so computed considered as shown by the taxpayer upon his return.

[Sec. 271 as amended by sec. 14 (a), Individual Income Tax Act 1944]

§ 39.271-1 *Deficiency defined.* (a) The term "deficiency" means the excess of the tax imposed by chapter 1 over the sum of the amount shown as the tax by the taxpayer upon his return and the amounts previously assessed (or collected without assessment) as a deficiency, but such sum shall first be reduced by the amount of rebates made. If no return is made, or if the return (except a return on Form 1040A pursuant to section 51 (f)) does not show any tax, for the purposes of the definition "the amount shown as the tax by the taxpayer upon his return" shall be considered as zero. Accordingly in any such case, if no deficiencies have been assessed, or collected without assessment, and no rebates have been made, the deficiency is the amount of the tax imposed by chapter 1. Additional tax shown on an "amended return," so-called, filed after the due date of the return for the taxable year, is a deficiency within the meaning of the Internal Revenue Code.

(b) For the purposes of the definition, the tax imposed by chapter 1 and the tax shown on the return shall both be determined without regard to the credit provided in section 35 for tax withheld at the source, and without regard to so much of the credit provided in section 32 for taxes withheld at the source as exceeds 2 percent of the interest on bonds containing a tax-free covenant. Payments on account of estimated tax, like other payments of tax by the taxpayer, shall likewise be disregarded in the determination of a deficiency.

(c) The computation by the district director of internal revenue, pursuant to section 51 (f) of the tax imposed by chapter 1 shall be considered as having been made by the taxpayer and the tax so computed shall be considered as the tax shown by the taxpayer upon his return.

(d) If so much of the credits claimed on the return for taxes withheld at the source as exceeds 2 percent of the interest on tax-free covenant bonds is greater than the amount of such credits allowable, the unpaid portion of the tax attributable to such difference will be collected not as a deficiency but as an underpayment of the tax shown on the return.

(e) This section may be illustrated by the following examples:

Example (1). The amount of tax shown by the taxpayer upon his return for the calendar year 1952 was $1,500. The taxpayer had no amounts previously assessed (or collected without assessment) as a deficiency. He claimed a credit in the amount of $2,000 for tax withheld at source on wages under section 1622, and a refund of $500 (not a rebate under section 271) was made to him as an overpayment of tax for the taxable year. It is later determined that the correct tax for the taxable year is $1,750. A deficiency of $250 is determined as follows:

Tax imposed by chapter 1		$1,750
Tax shown on return	$1,500	
Tax previously assessed (or collected without assessment) as a deficiency	None	
Total	1,500	
Amount of rebates made	None	
Balance		1,500
Deficiency		250

Example (2). The taxpayer made a return for the calendar year 1952 showing a tax of $1,250 before any credits for tax withheld at the source. He claimed a credit in the amount of $800 for tax withheld at source on wages under section 1622 and $60 for tax paid at source under section 143 upon interest on bonds containing a tax-free covenant. The taxpayer had no amounts previously assessed (or collected without assessment) as a deficiency. The Commissioner determines that the 2 percent tax paid at the source on tax-free covenant bonds is $40 instead of $60 as claimed by the taxpayer and that the tax imposed by chapter 1 is $1,360 (total tax $1,400 less $40 tax paid at source on tax-free covenant bonds). A deficiency in the amount of $170 is determined as follows:

Tax imposed by chapter 1 ($1,400 minus $40)		$1,360
Tax shown on return ($1,250 minus $60)	$1,190	
Tax previously assessed (or collected without assessment) as a deficiency	None	
Total	1,190	
Amount of rebates made	None	
Balance		1,190
Deficiency		170

Example (3). For the calendar year 1952, the taxpayer, a nonresident alien individual not engaged in trade or business within the United States, received gross income from sources within the United States consisting of dividends, and interest on bonds containing a tax-free covenant under which the tax liability assumed by the obligor does not exceed 2 percent of the interest. The taxpayer made a return showing a tax of $7,860 before any credits for tax withheld at the source. He claimed a credit of $6,000 under section 32 for tax withheld at the source under section 143 of which amount $5,600 was represented as tax withheld, and $400 was represented as the tax at 2 percent paid by the obligor on interest on tax-free covenant bonds described in section 143 (a). The Commissioner determines that the 2 percent tax paid by the obligor on interest on tax-free covenant bonds amounts to $200 instead of $400 as claimed by the taxpayer, and that the tax imposed by chapter 1 is $11,320 (total tax $11,520 less $200 tax paid by obligor on interest on tax-free covenant bonds). The Commissioner also determines that the tax withheld at the source amounts to $7,750 in addition to the $200 paid by the obligor of the bonds. A deficiency in the amount of $3,860 is determined as follows:

Tax imposed by chapter 1 ($11,520 minus $200)		$11,320
Tax shown on return ($7,860 minus $400)	$7,460	
Tax previously assessed (or collected without assessment) as a deficiency	None	
Total	7,460	
Amount of rebates made	None	
Balance		7,460
Deficiency		3,860

(f) As used in section 271, the term "rebate" means so much of an abatement, credit, refund, or other repayment as is made on the ground that the tax imposed by chapter 1 is less than the excess of (1) the amount shown as the tax by the taxpayer upon his return increased by the amount previously assessed (or collected without assessment) as a deficiency over (2) the amount of rebates previously made. For example, assume that the amount of the tax shown by the taxpayer upon his return for the taxable year is $600 and the amount claimed as a credit under section 35 for tax withheld at the source is $900. If the Commissioner determines that the tax imposed by chapter 1 is $600 and makes a refund of $300, no part of such refund constitutes a "rebate" since the refund is not made on the ground that the tax imposed by chapter 1 is less than the tax shown on the return. If, however, the Commissioner determines that the tax imposed by chapter 1 is $500 and refunds $400, the amount of $100 of such refund would constitute a rebate since it is made on the ground that the tax imposed by chapter 1 ($500) is less than the tax shown on the return ($600). The amount of such rebate ($100) would be taken into account in arriving at the amount of any deficiency subsequently determined.

§ 39.272 *Statutory provisions; assessment and collection of deficiencies; procedure.*

SEC. 272. *Procedure in general*—(a) (1) *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 chapter, 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 Saturday, 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 chapter 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 3653 (a) 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. If the notice is addressed to a person outside the States of the Union and the District of Columbia, the period specified in this paragraph shall be one hundred and fifty days in lieu of ninety days.

(2) *Cross references.* For exceptions to the restrictions imposed by this subsection, see—

Subsection (d) of this section, relating to waivers by the taxpayer;

Subsection (f) of this section, relating to notifications of mathematical errors appearing upon the face of the return;

Section 273, relating to jeopardy assessments;

Section 274, relating to bankruptcy and receiverships; and

Section 1145, 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 chapter the date on which a decision of the Board becomes final shall be determined according to the provisions of section 1140.

(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 prescribed 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 chapter, if mailed to the taxpayer at his last known address, shall be sufficient for the purposes of this chapter even if such taxpayer is deceased, or is under a legal disability, or, in the case of a corporation, has terminated its existence.

[Sec. 272 as amended by sec. 168 (a), Rev. Act 1942; sec. 203, Pub. Law 291 (79th Cong.)]

§ 39.272-1 *Assessment of a deficiency.* (a) If the Commissioner determines that there is a deficiency in respect of the income tax imposed by chapter 1 (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 section 272 (a) relating to separate residences, should be addressed to the Commissioner of Internal Revenue, Washington 25, D. C., attention Audit Services Branch, Audit Division. Within 90 days after notice of the deficiency is mailed (or within 150 days after mailing in the case of such a notice addressed to a person outside the States of the Union and the District of Columbia) as provided in section 272 (a) a petition may be filed with the Tax Court of the United States for a redetermination of the deficiency. In determining such 90-day or 150-day period, Saturday, Sunday, or a legal holiday in the District of Columbia is not to be counted as the 90th or 150th day. Except as stated in paragraphs (b) (c) (d) (e) and (f) of this section, no assessment of a deficiency in respect of a tax imposed by chapter 1 shall be made until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day or 150-day period, nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final. As to the date on which a decision of the Tax Court becomes final, see section 1140.

(b) 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 deficiency, and the taxpayer has no right to file a petition with the Tax Court upon the basis of such notice, nor is the assessment of such additional tax prohibited by the provisions of section 272 (a)

(c) 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 § 39.273-1.

(d) 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 §§ 39.274-1 and 39.274-2.

(e) (1) If the Tax Court 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 United States Court of Appeals, the filing of the petition will not operate as a stay of the assessment of any portion of the deficiency determined by the Tax Court unless he has filed a bond with the Tax Court as provided in section 1145. 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 Tax Court as the deficiency will be assessed immediately after the filing of such petition.

(2) If the Commissioner files a petition for review and (i) if the taxpayer has not filed a petition for review within three months after the decision of the Tax Court is rendered, or (ii) if such petition has been filed by the taxpayer, but the necessary bond referred to in section 1145 has not been filed with the Tax Court on or before the time his petition for review is filed, the amount determined by the Tax Court as the deficiency will be assessed in the case of (i), immediately after the expiration of the 3-month period, and in the case of (ii) immediately after the filing of the petition for review by the taxpayer.

(f) 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 Tax Court does not constitute filing with the Commissioner within the meaning of the Internal Revenue Code. 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.

(g) If a petition is filed with the Tax Court, 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 Tax Court 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 Tax Court, the entire amount redetermined as the deficiency by the decision of the Tax Court 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 Tax Court 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 Tax Court, or in section 273, relating to jeopardy assessments.

§ 39.272-2 *Collection of a deficiency.* Where a deficiency as redetermined by a decision of the Tax Court 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 unpaid portion of the amount so assessed shall be paid upon notice and demand from the district director of internal revenue. As to cases coming within the provisions of paragraphs (c), (d), and (e) of § 39.272-1, see sections 273 (i), 298, and 1145. As to interest on deficiencies, see section 292.

§ 39.272-3 *Extension of time for payment of a deficiency.* (a) If it is shown to the satisfaction of the district director (Commissioner if before September 1, 1953) 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 district director or 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. Section 272 (j) 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.

(b) An application for an extension of time for the payment of a deficiency should be made 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. The application must be verified by a written declaration that it is made under the penalties of perjury. A statement of assets and liabilities of the taxpayer and an itemized statement 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 district director of internal revenue. An application for an extension of time for the payment of a deficiency will not be considered unless request therefor is made to the district director of internal revenue on or before the date prescribed for payment thereof, as shown by the notice and demand from the district director of internal revenue or on or before the date or dates prescribed for payment in any prior extension granted.

(c) As a condition to the granting of such an extension, the Commissioner (after August 31, 1953, the district director) 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 6 U. S. C. 15. 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 district director of internal revenue. 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.

§ 39.273 *Statutory provisions; assessment and collection of deficiencies; jeopardy assessments.*

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 chapter.

§ 39.273-1 *Jeopardy assessments.* (a) 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 Tax Court of the United States is rendered, the jeopardy assessment may be made only with respect to the deficiency determined by The Tax Court. The Commissioner is prohibited from making a jeopardy assessment after a decision of The Tax Court has become final (see section 1140) or after the taxpayer has filed a petition for review of the decision of The Tax Court.

(b) 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 Tax Court for a redetermination of the amount of the deficiency within 90 days after such notice is mailed (or within 150 days after mailing in the case of such a notice addressed to a person outside the States of the Union and the District of Columbia) not counting

Saturday Sunday, or a legal holiday in the District of Columbia as the 90th or 150th day. The Commissioner may, at any time before the decision of The Tax Court 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 Tax Court, either before or after the making of the jeopardy assessment, the Commissioner is required to notify The Tax Court of such assessment or abatement, and The Tax Court 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).)

(c) After a jeopardy assessment has been made, the list showing such assessment will be immediately transmitted to the district director of internal revenue. Upon receipt of the list containing the assessment, the district director of internal revenue 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 Tax Court, 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 district director of internal revenue, unless before the expiration of such 10-day period he files with the district director of internal revenue 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 district director of internal revenue deems necessary and must be executed by sureties satisfactory to the district director of internal revenue. It must be conditioned upon the payment of so much of the amount included therein as is not abated by a decision of The Tax Court 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 Tax Court, it must contain a further condition that if a petition is not filed before the expiration of the 90-day or 150-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 or 150-day period. If a petition is not filed with The Tax Court within the 90-day or 150-day period, the district director of internal revenue 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 district director of internal revenue 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.

(d) 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 Tax Court is rendered, then the bond shall at the request of the taxpayer be proportionately reduced. If The Tax Court 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 Tax Court renders its decision.

(e) After The Tax Court has rendered its decision and such decision has become final, the district director of internal revenue will be notified of the action taken. The district director of internal revenue will then send notice and demand for the unpaid portion of the amount determined by The Tax Court, the collection of which has been stayed by the bond. The district director of internal revenue 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 Tax Court, 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 district director of internal revenue. If the amount included in the notice and demand made after the decision of The Tax Court 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 Tax Court, 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.

(f) As to bankruptcy proceedings for the relief of debtors and receivership proceedings, see sections 274 and 298 and §§ 39.274-1 and 39.274-2.

§ 39.274 *Statutory provisions; assessment and collection of deficiencies; bankruptcy and receiverships.*

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 chapter 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 6 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 chapter.

§ 39.274-1 *Bankruptcy and receivership proceedings.* (a) 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.

(b) As used in this section and § 39.274-2, the term "bankruptcy proceeding" includes proceedings under Chapters I to VII of the Bankruptcy Act (11 U. S. C. cc. I-VII) or under sections 75 or 77, or Chapters X-XIII of such act; 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 Chapter X by a court of competent jurisdiction or the filing of a petition under section 75 or Chapters XI to XIII with a court of competent jurisdiction.

(c) 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, Washington 25, D. C., of the adjudication of bankruptcy or the appointment of a receiver.

(d) District directors of internal revenue should, promptly after notice of outstanding liability against a taxpayer in any bankruptcy or receivership proceeding, and in any event within the time limited by the appropriate provisions of the Bankruptcy Act, 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. At the same time claim is filed with the bankruptcy or receivership court, the district director of internal revenue will send notice and demand for payment to the taxpayer together with a copy of such claim.

(e) Under section 3466 of the Revised Statutes and section 3467 of the Revised Statutes, as amended, and section 64 of the Bankruptcy Act, 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 the 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. Sections 75 (l) 77 (e), 199, 337 (2) 455, and 659 (6) of the Bankruptcy Act (11 U. S. C. 203 (l), 205 (e) 599, 737 (2) 855, and 1059 (6)) also contain provisions with respect to the rights of the United States relative to priority of payment. Bankruptcy courts have jurisdiction under the Bankruptcy Act 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. 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, and except to the extent which may be provided in a plan or arrangement duly effectuated in a bankruptcy proceeding. 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.

§ 39.274-2 *Immediate assessments in bankruptcy and receivership cases.* (a) If the Commissioner has determined that a deficiency is due in respect of income tax and the taxpayer has filed a petition with The Tax Court of the United States 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 The Tax Court as to that particular determination. No petition shall be filed with The Tax Court for a redetermination of the deficiency after the adjudication of bankruptcy or the appointment of a receiver.

(b) Claim for the amount of a deficiency, even though pending before The Tax Court for consideration, may be filed with the court in which the bankruptcy or receivership proceeding is pending without awaiting final decision of The Tax Court. In case of final decision of The Tax Court before the termination of the bankruptcy or receivership proceeding, a copy of The Tax Court's decision may be filed by the Commissioner with the court in which such proceeding is pending.

(c) 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.

(d) 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 district director of internal revenue 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 § 39.272-3.

(e) This section deals only with immediate assessments provided for in section 274 and the procedure in connection with such assessments.

§ 39.275-277 *Statutory provisions; assessment and collection of deficiencies; period of limitation; exceptions; suspension of running of period of limitation.*

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 chapter 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) *Constructive dividends.* If the taxpayer omits from gross income an amount properly includible therein—

(1) *Foreign personal-holding companies.* 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); or

(2) *Personal service corporations.* Under section 394 (b) (relating to the inclusion in the gross income of shareholders of their distributive shares of undistributed Supplement S net income of a personal service corporation);

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 chapter, 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. 275 as amended by sec. 503, Second Rev. Act 1940]

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 chapter 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.

(d) *Net operating loss carry-backs and unused excess profits credit carry-backs.* In the case of a deficiency attributable to the application to the taxpayer of a net operating loss carry-back or an unused excess profits credit carry-back, including deficiencies which may be assessed pursuant to the provisions of section 3780 (b) or (c), such deficiency may be assessed—

(1) * * * [Not applicable.]

(2) In case a return was not required under subchapter E of chapter 2 for the taxable year of the net operating loss or unused excess profits credit resulting in the carry-back, at any time before the expiration of the period within which (under section 275 or subsection (a) or (b) of this section) a deficiency (with respect to tax imposed either by chapter 1 or by subchapter A or B of chapter 2) for such taxable year (whichever is the longer period) may be assessed.

(e) *Gain upon sale or exchange of residence.* In the case of a deficiency described in section 112 (n) (7), such deficiency may be assessed at any time prior to the expiration of the time therein provided.

(f) *Involuntary conversion.* In the case of a deficiency described in section 112 (f) (3) (C) or (D), such deficiency may be assessed at any time prior to the expiration of the time therein provided.

[Sec. 276 as amended by sec. 5 (e), Tax Adjustment Act 1945; sec. 122 (f), Rev. Act 1945; sec. 318 (b) (5), Rev. Act 1951; sec. 1 (b), Pub. Law 251 (82d Cong.)]

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.

§ 39.275-1 *Period of limitation upon assessment of tax.* The amount of income tax imposed by the Internal Revenue Code 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 section (other than those provided for elsewhere in the Code) are as follows:

(a) 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 three 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—

(1) The written request notifies the Commissioner that the corporation contemplates dissolution at or before the expiration of such period,

(2) The dissolution is in good faith begun before the expiration of such period, and

(3) 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.

(b) If a corporation makes no income tax return under the Internal Revenue Code, 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.

(c) 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.

(d) 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.

(e) 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 (b) of this section.

(f) 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 (see sections 331 to 340, inclusive), or an amount properly includible therein under section 394 (b) as his distributive share of the Supplement S net income of a personal service corporation (see sections 391 to 396, inclusive) the tax may be assessed at any time within seven years after the return was filed.

(g) 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.

(h) 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.

(i) 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 Tax Court of the United States, until the decision of The Tax Court 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 Tax Court, 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.

(j) 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 §§ 39.274-1 and 39.274-2.

(k) A special period of limitation is provided in section 276 (d) within which a deficiency in any tax (including a deficiency which may be assessed pursuant to the provisions of section 3780 (b) or (c) relating to tentative carry-back ad-

justments) which is attributable to the application to the taxpayer of a net operating loss carry-back or an unused excess profits credit carry-back, may be assessed. The period within which such a deficiency may be assessed depends, in general, on the period within which a deficiency may be assessed with respect to the taxable year of the net operating loss or the unused excess profits credit which resulted in the carry-back. A deficiency in any tax attributable to the application to the taxpayer of a net operating loss carry-back or an unused excess profits credit carry-back may be assessed at any time prior to the expiration of the period within which (under the provisions of section 275 or 276 (a) or (b) or section 508 which makes such sections 275 and 276 (a) and (b) applicable to subchapter A of chapter 2) a deficiency may be assessed with respect to the same or any other tax imposed by chapter 1 or subchapter A of chapter 2 for the taxable year of the net operating loss or the unused excess profits credit which resulted in such carry-back. A deficiency attributable to the application to the taxpayer of the carry-back thus may be assessed at any time prior to the expiration of whichever of the following two periods, each period being determined under the applicable provisions of sections 275, 276 (a) and (b), and 508, expires the latest:

(1) The period within which a deficiency may be assessed with respect to the tax imposed by chapter 1 for the taxable year of the loss or unused credit which resulted in the carry-back; or

(2) The period within which a deficiency may be assessed with respect to the surtax on personal holding companies, imposed by subchapter A of chapter 2, for the taxable year of the loss or unused credit which resulted in the carry-back.

If a corporation is not a personal holding company, as defined in section 501, for the taxable year of the loss or unused credit which resulted in the carry-back, the period within which a deficiency may be assessed with respect to the surtax on personal holding companies for the taxable year of the loss or unused credit shall be disregarded in determining the period within which a deficiency attributable to the application to the taxpayer of a carry-back, resulting from such loss or unused credit, may be assessed. It is immaterial whether the deficiency is attributable to the application to the taxpayer of a net operating loss carry-back or an unused excess profits credit carry-back or whether the deficiency is in respect of the same tax as that of the carry-back or in respect of some other tax. It is likewise immaterial whether the tax, in respect of which the deficiency resulting from the application to the taxpayer of the carry-back is to be assessed, is the same kind of tax with respect to which a deficiency might be assessed for the taxable year of the loss or unused credit which resulted in the carry-back. Thus, if a deficiency for the calendar year 1952 with respect to the tax imposed by chapter 1 is attributable to the application to the taxpayer of a net operating loss carry-back from 1953, and if the periods within which deficiencies with respect to the taxes imposed by chapter 1 and subchapter A of chapter 2 for 1953 expire respectively on March 15, 1957, and September 15, 1957, the period within which such deficiency, attributable to the application to the taxpayer of the net operating loss carry-back from 1953, may be assessed with respect to the tax imposed by chapter 1 for 1952 will expire on September 15, 1957. A deficiency attributable to the application to the taxpayer of a carry-back may result from an adjustment to a net operating loss or an unused excess profits credit, to the resulting carry-back, or to the net operating loss deduction or the unused excess profits credit adjustment. A deficiency may be attributable to the application to the taxpayer of a carry-back even though the net operating loss or the unused excess profits credit or the resulting carry-back, as claimed by the taxpayer, is identical in amount with the actual loss or unused credit or the resulting carry-back. For example, if in computing a net operating loss deduction, the taxpayer fails to make the adjustment required by section 122 (c) the resulting deficiency will be considered to be attributable to the application to the taxpayer of any operating loss carry-back which entered into the computation of such net operating loss deduction. If the period within which a deficiency may be assessed under any other applicable provisions of law is longer than the period provided in section 276 (d) a deficiency attributable to the application to the taxpayer of such carry-back may be assessed at any time prior to the expiration of such longer period.

(l) In the case of a joint return made under section 51 (g), the period of limitations shall not be less than one year immediately after the date of the actual filing of such return, computed without regard to the provisions of section 51 (g) (7)

(m) For the period of limitations for assessing a deficiency attributable to an award made pursuant to the order issued by the Interstate Commerce Commission on December 4, 1950, under the Railway Mail Pay Act of 1916, see § 29.275-1 of Regulations 111 (26 C. F. R., 1949 ed., Supps.).

(n) In the case of a deficiency described in section 112 (n) (7), such deficiency may be assessed at any time before the expiration of the time therein provided. See § 39.112 (n)-1.

(o) In the case of a deficiency described in section 112 (f) (3) (C) or (D), such deficiency may be assessed at any time before the expiration of the time therein provided. See § 39.112 (f)-1.

(p) 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 (31 U. S. C. 192), see section 311.

(q) For the period of limitation for assessing amounts determined under section 127 (c) (3) (relating to war loss recoveries) or any deficiency attributable to the basis of recovered property being determined under section 127 (d) (2) see section 127 (c) (5) and the regulations thereunder.

§ 39.275-2 *Period of limitation upon collection of tax.* (a) In the case of the income taxes imposed by the Internal Revenue Code, a proceeding in court without assessment for the collection of such tax must be begun within three years after the return was filed.

(b) The exceptions to the period of limitation upon collection of the tax without assessment stated in paragraph (a) of this section 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 three 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 (1), (2) and (3) of paragraph (a) of § 39.275-1 also must be met.

(2) A proceeding in court for the collection of the tax without assessment may be begun at any time—

(i) In case the taxpayer files a false or fraudulent return with intent to evade tax; or

(ii) In case the taxpayer fails 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 (see sections 331 to 340, inclusive), or an amount properly includible therein under section 394 (b) as his distributive share of the Supplement S net income of a personal service corporation (see sections 391 to 396, inclusive), 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.

(6) In the case of a joint return made under section 51 (g) the period of limitations shall not be less than one year immediately after the date of the actual filing of such return, computed without regard to the provisions of section 51 (g) (7)

(c) 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.

(d) If a notice of a deficiency has been mailed to the taxpayer under the provisions of section 272 (a) (see § 39.272-1) 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 Tax Court of the United States, until the decision of the Tax Court becomes final) and for 60 days thereafter.

(e) 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 § 39.274-2.

SUPPLEMENT M—INTEREST AND ADDITIONS TO THE TAX

§ 39.291 *Statutory provisions; interest and additions to the tax; failure to file return.*

SEC. 291. *Failure to file return.* (a) In case of any failure to make and file return required by this chapter, 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 3612 (d) (1).

[Sec. 291 as amended by sec. 172 (f) (4), Rev. Act 1942; sec. 6 (b) (7), Individual Income Tax Act 1944]

§ 39.291-1 *Addition to the tax in case of failure to file return.* (a) In case of failure to make and file a return required by chapter 1 within the prescribed time, a certain percent of the amount of the tax is added to the tax unless 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.

(b) A taxpayer who 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 a written statement containing a declaration that it is made under penalties of perjury, which should be filed with the district director of internal revenue, who, unless otherwise directed by the Commissioner, will forward the statement to the Commissioner, 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.

(c) 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.

(d) 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 district directors of internal revenue or the Commissioner in the case of delinquency in filing a return, or in the case of a false or fraudulent return, see section 3612.

§ 39.292-294 *Statutory provisions; interest and additions to the tax; interest on deficiencies; additions to tax in case of deficiency; additions to tax in case of nonpayment.*

SEC. 292. *Interest on deficiencies*—(a) *General rule.* 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. If any portion of the deficiency assessed is not to be collected by reason of a prior satisfaction, in whole or in part, of the tax, proper adjustment shall be made with respect to the interest on such portion.

(b) *Deficiency resulting from relief under section 722.* * * * [Not applicable]

(c) *Deficiency resulting from carry-back and related matters.* If any part of a deficiency is determined by the Commissioner to be attributable (A) to a carry-back to which an overpayment described in section 3771 (e), or a decrease determined under section 3780 (b), in any other tax is attributable, or (B) to an error in the amount or effect of a carry-back which resulted in a credit or refund of an overpayment with interest computed pursuant to section 3771 (e), or in a decrease determined under section 3780 (b), no interest shall be assessed or paid under subsection (a) with respect to such part of the deficiency for any period during which interest was not allowed with respect to such overpayment or for a period prior to the application of such decrease.

(d) With respect to any corporation entitled to receive payment for the transportation of United States mail, if an award is retroactively received for the transportation of United States mail, and if such award is required to be treated as income in the year or years in which the mail was carried, then, notwithstanding the provisions of subsection (a) of this section, no interest shall be due, with respect to any period prior to thirty days after such award is granted, for tax deficiencies resulting from the inclusion of such additional mail payments retroactively.

[Sec. 292 as amended by Pub. Law 201 (78th Cong.); sec. 14 (c), Individual Income Tax Act 1944; sec. 6 (a), Tax Adjustment Act 1945; sec. 611 (b), Rev. Act 1951]

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 3612 (d) (2).

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 chapter, 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.

(d) *Estimated tax*—(1) *Failure to file declaration or pay installment of estimated tax*—(A) *Failure to file declaration.* In the case of a failure to make and file a declaration of estimated tax within the time prescribed, unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not to willful neglect, there shall be added to the tax 5 per centum of each installment due but unpaid, and in addition, with respect to each such installment due but unpaid, 1 per centum of the unpaid amount thereof for each month (except the first) or fraction thereof during which such amount remains unpaid. In no event shall the aggregate addition to the tax under this subparagraph with respect to any installment due but unpaid, exceed 10 per centum of the unpaid portion of such installment. For the purposes of this subparagraph the amount and due date of each installment shall be the same as if a declaration had been filed within the time prescribed showing an estimated tax equal to the correct tax reduced by the credits under sections 32 and 35.

(B) *Failure to pay installments of estimated tax declared.* Where a declaration of estimated tax has been made and filed within the time prescribed, or where a declaration of estimated tax has been made and filed after the time prescribed and the Commissioner has found that failure to make and file such declaration within the time prescribed was due to reasonable cause and not to willful neglect, in the case of a failure to pay an installment of the estimated tax within the time prescribed, unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not to willful neglect, there shall be added to the tax 5 per centum of the unpaid amount of such installment, and in addition 1 per centum of such unpaid amount for each month (except the first) or fraction thereof during which such amount remains unpaid. In no event shall the aggregate addition to the tax under this subparagraph with respect to any installment due but unpaid, exceed 10 per centum of the unpaid portion of such installment.

(2) *Substantial underestimate of estimated tax.* If 80 per centum of the tax (determined without regard to the credits under sections 32 and 35), in the case of individuals other than farmers exercising an election under section 60 (a), or 66⅔ per centum of such tax so determined in the case of such farmers, exceeds the estimated tax (increased by such credits), there shall be added to the tax an amount equal to such excess, or equal to 6 per centum of the amount by which such tax so determined exceeds the estimated tax so increased, whichever is the lesser. This paragraph shall not apply to the taxable year in which falls the death of the taxpayer, nor, under regulations prescribed by the Commissioner with the approval of the Secretary, shall it apply to the taxable year in which the taxpayer makes a timely payment of estimated tax within or before each quarter * * * [deleted material no longer applicable] of such year (or in the case of farmers exercising an election under section 60 (a), within the last quarter) in an amount at least as great as though computed (under such regulations) on the basis of the taxpayer's status with respect to the personal exemption and credit for dependents on the date of the filing of the declaration for such taxable year (or in the case of any such farmer, or in case the fifteenth day of the third month of the taxable year occurs after July 1, on July 1 of the taxable year) but otherwise on the basis of the facts shown on his return for the preceding taxable year. * * * [deleted material no longer applicable]

(3) *Tax on self-employment income.* This subsection shall be applied without regard to the tax imposed by subchapter E, relating to tax on self-employment income.

(e) *Substantial overstatement of expected carry-backs.* If the time for payment of any tax or taxes for any taxable year is extended under section 3779, there shall be added to such tax or taxes an amount equal to 5 per centum of the penalty portion, if any, of the amount to which such extension relates, unless the taxpayer establishes to the satisfaction of the Commissioner that, as of the end of the taxable year in which such extension was made, there was reasonable cause to expect there would be no such penalty portion. The penalty portion shall be the excess of the amount to which such extension relates which is not paid by the end of the taxable year in which such extension is made over 125 per centum of the amount to which such extension relates which is satisfied by applying thereto a decrease in tax in respect of an application under section 3780 (a) less any amounts assessed in respect of such application which are not so satisfied.

[Sec. 294 as amended by sec. 5 (b), Current Tax Payment Act 1943; sec. 118 (a), Rev. Act 1943; secs. 6 (b) (8), 13 (b), Individual Income Tax Act 1944; sec. 4 (b), Tax Adjustment Act 1945; sec. 208 (d) (8), Social Security Act Amendments 1950; sec. 2, Pub. Law 807 (81st Cong.); sec. 103 (b), Rev. Act 1951]

§ 39.294–1 *Additions to the tax*—(a) *In general.* Section 294 (d) provides for certain additions to the tax in the case of—

(1) Failure to file timely a declaration of estimated tax;

(2) Failure to pay within the time prescribed any installment of declared estimated tax; and

(3) Substantial underestimate of the estimated tax.

These additions to the tax are in addition to any applicable criminal penalties.

(b) *Additions for specific failures on the part of the taxpayer with respect to the estimated tax*—(1) *Failure to file declaration.* (i) Section 294 (d) (1) (A) provides for an addition to the tax in the case of a failure to make and file a declaration of estimated tax within the time prescribed unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not due to willful neglect. Such addition to the tax shall be in an amount equal to 5 percent of the unpaid amount of each installment and in addition 1 percent of the unpaid amount of the installment for each month (except the first) or fraction thereof during which such amount remains unpaid. Such addition to the tax with respect to any installment due but unpaid shall not exceed 10 percent of the unpaid portion of such installment. For the purposes of section 294 (d) (1) (A) the amount and due date of each installment shall be the same as if a declaration had been filed within the time prescribed showing an estimated tax equal to the correct tax reduced by the credits for tax withheld at source.

(ii) The application of section 294 (d) (1) (A) in the case of taxpayers not entitled to elect under section 60 (a) relating to farmers, may be illustrated by the following example:

Example. An individual filed a declaration on May 15, 1952, for the calendar year 1952, disclosing an estimated tax of $1,400, and paid installments of $350 each on May 15, June 15, and September 15, 1952, and January 15, 1953. In computing his estimated tax he correctly estimated the amount of tax to be withheld at source on his wages for 1952 to be $1,000. On March 15, 1953, he filed a return on Form 1040 showing a correct tax of $4,000 and paid the balance of the tax due, $1,600 ($4,000 less the sum of $1,400 and $1,000). Examination of his return disclosed that his entire income consisted of a regular salary, dividends, and interest. The failure to file a timely declaration was not due to reasonable cause. Hence the individual is subject to the penalty imposed by section 294 (d) (1) (A). Under the facts assumed, installments of tax in the amount of $750 each were due and payable on March 15, June 15, and September 15, 1952, and January 15, 1953, that is, one-fourth of $3,000, the balance of correct tax remaining after taking into account the amount withheld at source on his wages. The entire amount of the March installment of $750 remained unpaid for two months; $400 of the same installment remained unpaid for an additional ten months; $400 of the June installment remained unpaid for nine months; $400 of the September installment remained unpaid for six months; $400 of the January installment remained unpaid for two months. The addition to the tax under section 294 (d) (1) (A), subject to the limitation of 10 percent of the unpaid amount of each installment, is $179, computed as follows:

Unpaid amount	Percentage	Penalty before limitation	10 percent limitation	Addition to tax
March:				
$750	5 percent plus 1 percent	$45		
$400	10 times 1 percent	40		
		85	$75	$75
June: $400	5 percent plus 8 percent	52	40	40
September: $400	5 percent plus 5 percent	40	40	40
January: $400	5 percent plus 1 percent	24	40	24
Total addition to tax under sec. 294 (d) (1) (A)				179

(2) *Failure to pay installment of declared estimated tax.* (i) Section 294 (d) (1) (B) provides for an addition to the tax in the case of the failure to pay an installment of the declared estimated tax within the time prescribed unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not due to willful neglect. Such addition to the tax is applicable to delinquency in payment only (*a*) where a timely declaration of estimated tax has been made and filed or (*b*) where the Commissioner has found that the failure to make and file a timely declaration was due to reasonable cause and not to willful neglect. Such addition to the tax shall be in an amount equal to 5 percent of the unpaid amount of each installment of declared estimated tax and in addition 1 percent of such unpaid amount for each month (except the first) or fraction thereof during which such amount remains unpaid. The addition to the tax is limited with respect to any installment due but unpaid to 10 percent of the unpaid portion of such installment. Such addition to the tax is not applicable in cases to which the addition to the tax under section 294 (d) (1) (A) applies.

(ii) The application of section 294 (d) (1) (B) in the case of taxpayers not entitled to elect under section 60 (a) relating to farmers, may be illustrated by the following examples:

Example (1). For the calendar year 1952 E and F, husband and wife, file timely declarations. E's separate declaration discloses a balance of estimated tax in the amount of $400. Instead of making timely payment of one installment of $100, he pays such amount 10 days after the due date. The delay in payment was not due to reasonable cause. F is similarly delinquent with respect to one installment of $50 of her balance of estimated tax of $200. On the joint return of E and F for 1952 the addition to the tax with respect to the delinquent installments of estimated tax will be $7.50, which is the sum of 5 percent of $100 and 5 percent of $50.

Example (2). The timely joint declaration of G and H for the calendar year 1952 discloses a balance of estimated tax in the amount of $500. G and H are delinquent without reasonable cause for a period of less than one month in the payment of one installment of $125. They file separate income tax returns for 1952. They are jointly and severally liable for the payment of the addition to the tax for delay in paying an installment of estimated tax. Such addition amounts to $6.25, that is, 5 percent of $125.

(3) *Substantial understatement of estimated tax.* (i) Section 294 (d) (2) provides for an addition to the tax in the case of a taxpayer who makes a substantial underestimate of tax on his declaration. Such addition to the tax shall not apply to the taxable year in which falls the death of the taxpayer. Except as hereinafter provided—

(*a*) In the case of individuals, other than those exercising the election under section 60 (a) relating to farmers, an addition to the tax under section 294 (d) (2) is applicable in the event that the amount of the estimated tax (increased by the amount of the credit for taxes withheld at source on wages (under section 35 and the credit under section 32) is less than 80 percent of the tax imposed by chapter 1 for the taxable year (determined without regard to such credits) In the event of a failure to file the required declaration, the amount of the estimated tax for the purposes of this provision is zero.

(*b*) In the case of individuals exercising the election under section 60 (a) relating to farmers, the addition to the tax is applicable if the amount of the estimated tax increased by the amount of the credit for taxes withheld at source on wages under section 35 and the credit under section 32 is less than 66⅔ percent of the amount of the tax (determined without regard to such credits)

(c) The addition to the tax in any case in which there has been such underestimate as comes within the scope of section 294 (d) (2) is an amount equal to—

(*1*) The excess of 80 percent of the tax (or 66⅔ percent in the case of farmers exercising an option under section 60 (a)) determined without regard to the credit for taxes withheld at source on wages under section 35 and the credit under section 32 over the amount of the estimated tax increased by such credits; or

(*2*) 6 percent of the excess of the tax determined without regard to the credit for taxes withheld at source on wages under section 35 and the credit under section 32 over the amount of the estimated tax increased by such credits,

whichever is the lesser.

(ii) The addition to the tax for substantial underestimate of the estimated tax shall not apply to the taxable year in which the taxpayer makes a timely payment of estimated tax within or before each quarter of such year in an amount at least as great as though such estimated tax were computed under the law applicable to the taxable year on the basis of the taxpayer's status with respect to the personal exemption and credit for dependents on the date of filing the declaration, and on the basis of the tax withheld, and reasonably expected on the date of the filing of the declaration to be withheld, on wages received during the calendar year ending with or within the taxable year, but otherwise as though such estimated tax were computed on the basis of the net income and the surtax net income shown on the taxpayer's return for the preceding taxable year, adjusted to conform to the law applicable to the taxable year. The net income and the surtax net income shown on the taxpayer's return for the preceding taxable year shall be considered to be zero for the purposes of this section if for such year the taxpayer did not file a return and was not required to file a return. In the case of farmers exercising an election under section 60 (a) such addition to the tax shall not apply to the taxable year in which the taxpayer makes a timely payment of estimated tax within the last quarter of such year in an amount at least as great as though computed under the law applicable to the taxable year on the basis of the taxpayer's status with respect to the personal exemption and credit for dependents on the date of filing the declaration, but otherwise as though computed on the basis of the net income and the surtax net income shown on the taxpayer's return for the preceding taxable year, adjusted to conform to the law applicable to the taxable year.

(iii) As used in subdivision (ii) of this subparagraph, the expression "personal exemption and credit for dependents" shall be taken to refer to the exemptions for both normal tax and surtax under section 25 (b) (1), the expression "each quarter" shall be taken to include the period (ending with the fifteenth day of the first month of the succeeding taxable year) within which the last installment of the estimated tax is required to be paid; and the expression "last quarter" shall mean the period (similarly ending with the fifteenth day of the first month of the succeeding taxable year) within which farmers exercising an election under section 60 (a) are required to pay the estimated tax.

(iv) The application of section 294 (d) (2) in the case of taxpayers not entitled to elect under section 60 (a) relating to farmers, may be illustrated by the following examples:

Example (*1*). A, a professional man made a return on January 10, 1953, for the calendar year 1952. A was entitled to two exemptions for 1952. However, for 1953 he was entitled to only one exemption and he was not the head of a household. On March 15, 1953, A filed a declaration of estimated tax on which estimated tax for 1953 was shown in the amount of $11,000. He made payment of the estimated tax in four installments of $2,750 each on March 15, June 15, and September 15, 1953, and January 15, 1954. As a result of a transaction occurring in December 1953, A received taxable income in an amount which made him subject to a tax for the calendar year 1953 in the amount of $15,000. A's tax at 1953 rates on 1952 income amounts to $10,940 computed as follows:

Gross income shown on return for 1952	$30,000
Less: Deductions	5,000
Net income	25,000
Less: Exemption	600
Income subject to tax	24,400
Normal tax	732
Surtax	10,208
Total tax on basis of 1952 income	10,940

Since the installments of $2,750 each were timely paid for each quarter and each was at least as great as one-fourth of $10,940, A is not subject to the penalty for underestimating the tax for 1953.

Example (2). C, a single individual (and not the head of a household) with no dependents, received a salary of $5,200 for the calendar year 1951. He had other income of $1,000 for such calendar year. C's deductions for such calendar year amounted to $700. His salary was increased to $5,800 per annum on January 1, 1952. On March 15, 1952, at which time C's status for exemption purposes had not changed, he filed a declaration of estimated tax for the calendar year 1952. In computing his estimated tax, he used a gross income of $6,200 (his income for 1952) and deductions of $700. He also used one exemption and the rates for 1952. Since his salary had been increased to $5,800 per annum on January 1, 1952, he computed his estimated tax withheld and to be withheld during the entire year (on the excess of $5,800 over the exemption for withholding of

$667) as $1,026.60, at the rate of 20 percent. C's declaration showed a balance of estimated tax of $170.40 after taking credit for the estimated amount of tax withheld ($1,026.60) against a tax of $1,197, which balance he paid in quarterly installments. He received more income in 1952 than anticipated at the time he filed his declaration for 1952 and his correct tax liability after deducting the amount withheld from his wages and the amount paid pursuant to his declaration was $1,500. C computed his estimated tax for 1952 (1) under the law applicable to the taxable year 1952 on the basis of his status with respect to the personal exemption and credit for dependents on the date of filing his declaration for 1952, (2) on the basis of the tax withheld, and reasonably expected on the date of the declaration to be withheld, on wages received during 1952, and (3) otherwise on the basis of the net income and the surtax net income shown on his return for the taxable year 1951, adjusted to conform to the law applicable to the year 1952 and, hence, C is not subject to the addition to the tax for substantial underestimate of the estimated tax, even though the estimate was less than 80 percent of his tax liability for 1952.

(c) *Tax on self-employment income.* The provisions of section 294 (d) and of this section shall be applied without regard to the tax on self-employment income imposed by section 480.

§ 39.294-2 *Substantial overestimate of expected carry-backs.* (a) Section 294 (e) provides for an addition to the tax in case the amount of tax the time for payment of which has been extended under section 3779 is substantially in excess of the amount the time for payment of which might properly have been extended. Such addition to the tax is in addition to the interest payable under section 3779 (i) to any other applicable additions to the tax, and to any applicable criminal penalties.

(b) Section 294 (e) provides that if the time for payment of any amount of tax or taxes has been extended under section 3779, there shall be added to such tax or taxes an amount equal to 5 percent of the penalty portion, if any, of the amount to which such extension relates unless the taxpayer establishes to the satisfaction of the Commissioner that, as of the end of the taxable year in which the extension was made, there was reasonable cause to expect that there would be no such penalty portion. If the extension of time under section 3779 relates to more than one tax any addition to the tax under section 294 (e) will, in the discretion of the Commissioner, be added to any one tax or prorated among two or more of such taxes in any proportion he deems advisable.

(c) The "penalty portion" is the excess of—

(1) The amount to which an extension relates which is not paid by the end of the taxable year in which the extension was made, over

(2) 125 percent of (i) the amount to which such extension relates which is satisfied by applying or crediting thereto a decrease in tax determined in respect of an application for a tentative carry-back adjustment under section 3780, less (ii) any amounts assessed in respect of such application which are not so satisfied.

The penalty portion in effect, therefore, is the excess of the amount of tax the time for payment of which was extended over 125 percent of the amount the time for payment of which might properly have been extended. The amount the time for overpayment of which might properly have been extended in the net amount to which the extension relates which is satisfied by applying or crediting thereto a decrease in tax determined in respect of an application for a tentative carry-back adjustment under section 3780.

(d) Any amount to which an extension under section 3779 relates which is paid before the end of the taxable year in which the extension was made shall not to be deemed to be an amount the time for payment of which was extended in determining under section 294 (e) whether the amount the time for payment of which was extended was substantially in excess of the amount the time for payment of which might properly have been extended. Interest on any amount so paid before the end of the taxable year in which the extension was made will be payable at the rate of 6 percent per annum.

(e) The computation of the penalty portion and the resulting addition to the tax may be illustrated by the following example:

Example. Corporation X, which came into existence on January 1, 1952, and which keeps its books and makes its tax returns on the calendar year basis, filed a statement under section 3779 on March 15, 1953, extending the time for payment of $855 of its income tax for 1952. The extension was based on an expected net operating loss carry-back from 1953, and no part of the amount to which the extension related was paid before the end of 1953. The corporation in fact had a net operating loss for 1953, and on March 31, 1954, it filed an application under section 3780 (a) for a tentative carry-back adjustment with respect to the resulting carry-back from 1953. The application showed that the corporation's income tax for 1952 was decreased by $455 as a result of such carry-back from 1953. The Commissioner allowed the application in full on June 29, 1954. The $455 decrease in the corporation's income tax for 1952 was applied against the $855 of its income tax for 1952, the time for payment of which had been extended pursuant to the statement filed under section 3779 on March 15, 1953. Since the decrease in the corporation's income tax for 1952 was only $455, the corporation paid the remainder of $400 for 1952 in cash. The penalty portion is $286.25, and the addition to the tax is $14.31. These amounts are computed as follows:

Amount to which extension under section 3779 related which was not paid before the end of 1953	$855.00
125 percent of $455 (amount of tax time for payment of which might properly be extended)	568.75
The penalty portion	286.25
Addition to the tax (5 percent of $286.25)	14.31

Since the reduction, attributable to the net operating loss carry-back from 1953, in the aggregate of all of Corporation X's taxes previously determined for taxable years before 1953 was only $455, the corporation properly should not have extended under section 3779 the time for payment of an amount greater than $455. The penalty portion accordingly is the excess of the amount the time for payment of which was extended over 125 percent of the amount the time for payment of which might properly have been extended. The above addition to the tax, in the amount of $14.31, will be added to the income tax for 1952 and collected as part of such tax unless Corporation X establishes to the satisfaction of the Commissioner that as of December 31, 1953, there was reasonable cause to expect that there would be no penalty portion.

§ 39.295-299 *Statutory provisions; interest and additions to tax; time extended for payment of tax shown on return; time extended for payment of deficiency; interest in case of jeopardy assessments; bankruptcy and receiverships; removal of property or departure from United States.*

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 per centum 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 conceal-

ing property in such manner as to hinder collection of the tax, see section 146.

SUPPLEMENT N—CLAIMS AGAINST TRANSFEREES AND FIDUCIARIES

§ 39.311 *Statutory provisions; claims against transferees and fiduciaries; transferred assets.*

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 chapter (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 chapter.

(2) *Fiduciaries.* The liability of a fiduciary under section 3467 of the Revised Statutes, as amended (U. S. C. Title 31, sec. 192), 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 chapter, if mailed to the person subject to the liability at his last known address, shall be sufficient for the purposes of this chapter 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.

§ 39.311-1 *Claims in cases of transferred assets.* (a) 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 (31 U. S. C. 192) in respect of any income tax imposed by chapter 1, 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 chapter 1, 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 Tax Court of the United States, and the filing of a petition for review of the Tax Court's decision, are included in the sections of the Internal Revenue Code (and regulations pertaining thereto) relating to deficiencies in tax imposed by chapter 1.

(b) As used in this section, the term "transferee" 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.

(c) The period of limitation for assessment of the liability of a transferee or of a fiduciary, referred to in paragraph (a) of this section, 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 to 277, inclusive)

(2) In the case of the liability 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.

(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.

(d) 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 exisence not occurred.

(e) 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 Tax Court, until the decision of The Tax Court becomes final), and for 60 days thereafter.

§ 39.312 *Statutory provisions; claims against transferees and fiduciaries; notice of fiduciary relationship.*

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 chapter (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 privi-

leges 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.

§ 39.312-1 *Fiduciaries.* (a) 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 chapter 1. 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 (31 U. S. C. 192) 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 (February 26, 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.

(b) If the notice of the fiduciary capacity described in paragraph (a) of this section is not filed with the Commissioner before 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 Internal Revenue Code, 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 Tax Court of the United States within 90 days after the mailing of the notice (or within 150 days after mailing in the case of such a notice addressed to a person outside the States of the Union and the District of Columbia) 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 or 150-day period, and demand for payment will be made by the district director of internal revenue.

(c) The term "fiduciary" is defined in section 3797 (a) (6) to mean a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.

(d) This section, 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 Internal Revenue Code.

§ 39.313 *Statutory provisions; claims against transferees and fiduciaries; cross reference.*

SEC. 313. *Cross reference.* For prohibition of suits to restrain enforcement of liability of transferee or fiduciary, see section 3653 (b).

SUPPLEMENT O—OVERPAYMENTS

§ 39.321-322 *Statutory provisions; overpayment of installment of tax; refunds and credits.*

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*—(1) *Overpayment.* Where there has been an overpayment of any tax imposed by this chapter, 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.

(2) *Excessive withholding.* Where the amount of the tax withheld at the source under Subchapter D of Chapter 9 exceeds the taxes imposed by this chapter against which the tax so withheld may be credited under section 35, the amount of such excess shall be considered an overpayment.

(3) *Credits against estimated tax.* The Commissioner is authorized to prescribe, with the approval of the Secretary, regulations providing for the crediting against the estimated tax for any taxable year of the amount determined by the taxpayer or the Commissioner to be an overpayment of the tax for a preceding taxable year.

(4) *Credit for "special refunds" of employee social security tax.* The Commissioner is authorized to prescribe, with the approval of the Secretary, regulations providing for the crediting against the tax imposed by this chapter for any taxable year of the amount determined by the taxpayer or the Commissioner to be allowable under section 1401 (d) as a special refund of tax imposed on wages received during the calendar year in which such taxable year begins. If more than one taxable year begins in such calendar year, such amount shall not be allowed under this section as a credit against the tax for any taxable year other than the last taxable year so beginning. The amount allowed as a credit under such regulations shall, for the purposes of this chapter, be considered an amount deducted and withheld at the source as tax under Subchapter D of Chapter 9.

(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—

(A) If a return was filed by the taxpayer, and the claim was filed within three years from the time the return was filed, during the three years immediately preceding the filing of the claim.

(B) If a claim was filed, and (i) no return was filed, or (ii) if the claim was not filed within three years from the time the return was filed by the taxpayer, during the two years immediately preceding the filing of the claim.

(C) If no claim was filed and the allowance of credit or refund is made within three years from the time the return was filed by the taxpayer, during the three years immediately preceding the allowance of the credit or refund.

(D) If no claim was filed, and (i) no return was filed or (ii) the allowance of the credit or refund is not made within three years from the time the return was filed by the taxpayer, during the two years immediately preceding the allowance of the credit or refund.

(3) *Exceptions in the case of waivers.* If both the Commissioner and the taxpayer have, within the period prescribed in paragraph (1) for the filing of a claim for credit or refund, agreed in writing under the provisions of section 276 (b) to extend beyond the period prescribed in section 275 the time within which the Commissioner may make an assessment, the period within which a claim for credit or refund may be filed, or credit or refund allowed or made if no claim is filed, shall be the period within which the Commissioner may make an assessment pursuant to such agreement or any extension thereof, and six months thereafter, except that the provisions of paragraph (1) shall apply to any claim filed, or credit or refund allowed or made, before the execution of such agreement. The amount of the credit or refund shall not exceed the total of the portions of tax paid (A) during the two years immediately preceding the execution of such agreement, or, if such agreement was executed within three years from the time the return was filed, during the three years immediately preceding the execution of such

agreement, (B) after the execution of the agreement and before the expiration of the period within which the Commissioner might make an assessment pursuant to such agreement or any extension thereof, and (C) during six months after the expiration of such period, except that the provisions of paragraph (2) shall apply to any claim filed, or credit or refund allowed, before the execution of the agreement. Notwithstanding the foregoing provisions of this paragraph, the period within which a claim for credit or refund may be filed, or credit or refund allowed or made if no claim is filed, shall not expire prior to two years after the time the tax was paid, but if a claim is filed, or credit or refund allowed or made if no claim is filed, more than six months after the expiration of the period within which the Commissioner may make an assessment pursuant to such agreement or any extension thereof, the amount of the credit or refund shall not exceed the portion of the tax paid during the two years immediately preceding the filing of the claim, or, if no claim is filed, immediately preceding the allowance of the credit or refund.

(4) *Return considered filed on due date.* For the purposes of this subsection, a return filed before the last day prescribed by law for the filing thereof shall be considered as filed on such last day. For the purposes of paragraphs (2) and (3) of this subsection, and for the purposes of subsection (d) of this section, an advance payment of any portion of the tax made at the time such return was filed shall be considered as made on the last day prescribed by law for the payment of the tax or, if the taxpayer elected to pay the tax in installments, on the last day prescribed for the payment of the first installment. For the purposes of this paragraph, the last day prescribed by law for filing the return or paying the tax shall be determined without regard to any extension of time granted the taxpayer.

(5) *Special period of limitation with respect to bad debts and worthless securities.* If the claim for credit or refund relates to an overpayment on account of—

(A) The deductibility by the taxpayer, under section 23 (k) (1), section 23 (k) (4), or section 204 (c), of a debt as a debt which became worthless, or, under section 23 (g) (2) or (k) (2), of a loss from worthlessness of a security, or

(B) The effect that the deductibility of a debt or loss described in subparagraph (A) has on the application to the taxpayer of a carry-over,

in lieu of the three-year period of limitation prescribed in paragraph (1), the period shall be 7 years from the date prescribed by law for filing the return for the year with respect to which the claim is made. If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of such a debt or loss has on the application to the taxpayer of a carry-back, the period shall be either seven years from the date prescribed by law for filing the return for the year of the net operating loss or the unused excess profits credit which results in such carry-back or the period prescribed in paragraph (6), whichever expires the later. In the case of a claim described in this paragraph, the amount of the credit or refund may exceed the portion of the tax paid within the period prescribed in paragraph (2) or (3), whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of items described in this paragraph.

(6) *Special period of limitation with respect to net operating loss carry-backs and unused excess profits credit carry-backs.* If the claim for credit or refund relates to an overpayment attributable to a net operating loss carry-back or to an unused excess profits credit carry-back, in lieu of the three-year period of limitation prescribed in paragraph (1), the period shall be that period which ends with the expiration of the fifteenth day of the thirty-ninth month following the end of the taxable year of the net operating loss or the unused excess profits credit which results in such carry-back, or the period prescribed in paragraph (3) in respect of such taxable year, whichever expires later. In the case of such a claim, the amount of the credit or refund may exceed the portion of the tax paid within the period provided in paragraph (2) or (3), whichever is applicable, to the extent of the amount of the overpayment attributable to such carry-back.

(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, or finds that there is a deficiency but that the taxpayer has made an overpayment of tax in respect of such taxable year, 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 (1) that such portion was paid (A) within two years before the filing of the claim, the mailing of the notice of deficiency, or the execution of an agreement by both the Commissioner and the taxpayer pursuant to section 276 (b) to extend beyond the time prescribed in section 275 the time within which the Commissioner might assess the tax, whichever is earliest, or (B) within three years before the filing of the claim, the mailing of the notice of deficiency, or the execution of the agreement, whichever is earliest, if the claim was filed, the notice of deficiency mailed, or the agreement executed within three years from the time the return was filed by the taxpayer, or (C) after the execution of such an agreement and before the expiration of the period within which the Commissioner might make an assessment pursuant to such agreement or any extension thereof, or (D) after the mailing of the notice of deficiency; or (2), if such portion was not paid within the period described in clause (1), but the notice of deficiency was mailed within seven years from the time prescribed for the filing of the return, or a claim described in subsection (b) (5) was filed, that such portion does not exceed the amount of the overpayment attributable to the deductibility of items described in subsection (b) (5); or (3), if such portion was not paid within the period described in clause (1) but the notice of deficiency was mailed within the period prescribed in subsection (b) (6) for the filing of a claim for credit or refund of an overpayment attributable to a carry-back, or such a claim was filed, that such portion does not exceed the amount of the overpayment attributable to a carry-back.

(e) *Presumption as to date of payment.* For the purposes of this section, any tax actually deducted and withheld at the source during any calendar year under Subchapter D of Chapter 9 shall, in respect of the recipient of the income, be deemed to have been paid by him not earlier than the fifteenth day of the third month following the close of his taxable year with respect to which such tax is allowable as a credit under section 35. For the purposes of this section, any amount paid as estimated tax for any taxable year shall be deemed to have been paid not earlier than the fifteenth day of the third month following the close of such taxable year.

(f) *Tax withheld at source.* For refund or credit in case of withholding agent, see section 143 (f). For refund or credit in case of employer required to deduct and withhold tax on wages, see section 1622 (f).

(g) *Overpayments attributable to net operating loss carry-backs and unused excess profits credit carry-backs.* If the allowance of a credit or refund of an overpayment of tax attributable to a net operating loss carry-back or to an unused excess profits credit carry-back is otherwise prevented by the operation of any law or rule of law other than section 3761, relating to compromises, such credit or refund may be allowed or made, if claim therefor is filed within the period provided in subsection (b) (6). If the allowance of an application, credit or refund of a decrease in tax determined under section 3780 (b) is otherwise prevented by the operation of any law or rule of law other than section 3761, such application, credit or refund may be allowed or made if application for a tentative carry-back adjustment is made within the period provided in section 3780 (a). In the case of any such claim for credit or refund or any such application for a tentative carry-back adjustment, the determination by any court, including the Tax Court of the United States, in any proceeding in which the decision of the court has become final, shall be conclusive except with respect to the net operating loss deduction and the unused excess profits credit adjustment, and the effect of such deduction or adjustment, to the extent that such deduction or adjustment is affected by a carry-back which was not in issue in such proceeding.

[Sec. 322 as amended by secs. 169 and 172 (e), Rev. Act 1942; secs. 2 (b) (2) and 4 (a) and (b), Current Tax Payment Act 1943; secs. 6 (b) (9) and (10) and 14 (d), Individual Income Tax Act 1944; sec. 5 (a), (b), (c), and (d), Tax Adjustment Act 1945; sec. 122 (e) (1), Rev. Act 1945; sec. 1, Pub. Law 716 (81st Cong.); sec. 206 (b) (1), Social Security Act Amendments 1950]

§ 39.322–1 *Authority for abatement, credit, and refund of tax.* Authority for the credit and refund of any overpayment of any income tax imposed by chapter 1 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 chapter 1.

§ 39.322–2 *Credit and refund adjustments.* Credits or refunds of overpayments may not be allowed or made after the expiration of the statutory period of limitation properly applicable unless, before the expiration of such period, a

claim therefor has been filed by the taxpayer. The claim, together with appropriate supporting evidence, must be filed in the office of the district director of internal revenue for the internal revenue 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 3771 and 28 U. S. C. 2411.

§ 39.322-3 *Claims for refund by taxpayers.* (a) 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, or on Form 1040 or 1040A, or an amended return, and should be filed with the district director of internal revenue. A separate claim shall be made for each taxable year or period.

(b) 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 before the expiration of such period. The claim must set forth in detail each ground upon which a refund is claimed, and facts sufficient to apprise the Commissioner of the exact basis thereof. The statements of the grounds and facts must be verified by a written declaration that they are made under the penalties of perjury. A properly executed return on Form 1040 shall, at the election of the taxpayer, constitute a claim for refund or credit within the meaning of section 322 for the amount of the overpayment disclosed by such return. For the purposes of section 322, such claim shall be considered as filed on the date on which such return is considered as filed. An election to treat the return as a claim for refund or credit shall be evidenced by a statement on the return setting forth the amount determined as an overpayment and advising whether such amount shall be refunded to the taxpayer or shall be applied as a credit against the taxpayer's estimated tax for the taxable year immediately succeeding the taxable year for which such return is filed. If the taxpayer elects to have all or part of the overpayment shown by his return applied to his estimated tax for his succeeding taxable year, no interest shall be allowed on such portion of the overpayment credited and such amount shall be applied as a payment on account of the estimated tax for such year or the installments thereof. The filing of a properly executed return on Form 1040A shall constitute an election by the taxpayer to have the return treated as a claim for refund and such return shall constitute a claim for refund within the meaning of section 322 for the amount of the overpayment shown by the district director's computation of the tax on the basis of the return. For the purposes of section 322, such claim shall be considered as filed on the date on which such return is considered as filed. In any case in which a taxpayer elects to have an overpayment refunded to him he may not thereafter change his election to have the overpayment applied as a payment on account of his estimated tax. 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 §§ 39.322-7 to 39.322-11, inclusive.

(c) If a return is filed by an individual and, after his death, a refund claim is filed by his legal representative, 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 legal representative to file the claim. 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 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.

(d) A claim may be executed by an agent of the person assessed, but in such case a power of attorney must accompany the claim.

(e) 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 (31 U. S. C. 203)

(f) 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 §§ 39.322-4 to 39.322-6, inclusive.

§ 39.322-4 *Claim for payment of judgment obtained against district director.* (a) A claim for the amount of a judgment against a district director of internal revenue for the recovery of taxes, penalties, or other sums should be made on a properly executed Form 843, and filed directly with the Commissioner of Internal Revenue, Washington 25, D. C. The claim must be verified by a written declaration that it is made under the penalties of perjury. 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, 28 U. S. C. 2006 provides:

SEC. 2006. *Execution against revenue officer.* Execution shall not issue against a collector or other revenue officer on a final judgment in any proceeding against him for any of his acts, or for the recovery of any money exacted by or paid to him and subsequently paid into the Treasury, in performing his official duties, if the court certifies that:

(1) Probable cause existed; or

(2) The officer acted under the directions of the Secretary of the Treasury or other proper Government officer.

When such certificate has been issued, the amount of the judgment shall be paid out of the proper appropriation by 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 § 39.322-3.

§ 39.322-5 *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 on a properly executed Form 843 and filed directly with the Commissioner of Internal Revenue, Washington 25, D. C. The claim must be verified by a written declaration that it is made under the penalties of perjury. 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.

§ 39.322-6 *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 on a properly executed Form 843 and filed directly with the Com-

missioner of Internal Revenue, Washington 25, D. C. The claim must be verified by a written declaration that it is made under the penalties of perjury. The claim shall be 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.

§ 39.322-7 *Limitations upon crediting and refunding of taxes paid, general rule.* (a) Unless a claim for credit or refund of an overpayment 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 chapter 1 for such year 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—

(1) If a return was filed by the taxpayer, and the claim was filed within three years from the time the return was filed, during the three years immediately preceding the filing of the claim.

(2) If a claim was filed, and (i) no return was filed, or (ii) if the claim was not filed within three years from the time the return was filed by the taxpayer, during the two years immediately preceding the filing of the claim.

(3) If no claim was filed and the allowance of credit or refund is made within three years from the time the return was filed by the taxpayer, during the three years immediately preceding the allowance of the credit or refund.

(4) If no claim was filed, and (i) no return was filed or (ii) the allowance of the credit or refund is not made within three years from the time the return was filed by the taxpayer, during the two years immediately preceding the allowance of the credit or refund.

(b) For the purposes of this section and §§ 39.322-8 to 39.322-11, inclusive, a return filed before the last day prescribed by law for the filing thereof, or an advance payment of any portion of the tax made before such date, shall be considered as filed or made on the last day prescribed by law for the filing of such return or the payment of such tax. If the taxpayer elected to pay the tax in installments, such an advance payment shall be considered as made on the last day prescribed for the payment of the first installment, but in all cases the last day prescribed by law for filing the return or paying the tax shall be determined without regard to any extension of time granted the taxpayer for filing the return or paying the tax. The provisions of this section are subject to the exceptions provided in §§ 39.322-8 to 39.322-11, inclusive.

(c) In the case of a filing of a joint return under section 51 (g) the joint return shall be deemed to have been filed on the last date prescribed by law for filing the return for such taxable year, determined without regard to any extension of time granted to either spouse for filing the return or paying the tax. See § 39.51-1 (b) (3) (iii)

(d) For special provisions in the case of an overpayment resulting from the application of section 127 (c) (3) (relating to war loss recoveries) see section 127 (c) (5) and the regulations thereunder.

§ 39.322-8 *Limitations upon crediting and refunding of taxes paid, in case waiver executed.* (a) If the Commissioner and 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, whichever period expires the later, have agreed in writing under the provisions of sections 276 (b) to extend beyond the period prescribed in section 275 the time within which the Commissioner may make an assessment, then the period within which a claim for credit or refund may be filed, or a credit or refund may be allowed or made if no claim is filed, is the period within which the Commissioner may make an assessment pursuant to such agreement or any extension thereof, and for six months thereafter. The amount of the credit or refund in such case shall not, however, exceed the sum of—

(1) The portion of the tax paid during the two years immediately preceding the execution of the agreement between the Commissioner and the taxpayer, or, if such agreement was executed within three years from the time the return was filed, during the three years immediately preceding the execution of such agreement;

(2) The portion of the tax paid after the execution of the agreement between the Commissioner and the taxpayer and before the expiration of the period within which the Commissioner might make an assessment pursuant to such agreement or any extension thereof; and

(3) The portion of tax paid during the six months immediately following the expiration of the period within which the Commissioner might make an assessment pursuant to the agreement between the Commissioner and the taxpayer or any extension of such agreement.

(b) If any portion of the tax is paid within six months after the expiration of the period within which the Commissioner might make an assessment pursuant to an agreement between the Commissioner and the taxpayer or any extension thereof, and if credit or refund is allowed or made after such payment and before the end of such 6-month period, or if claim for credit or refund is filed after such payment and before the end of such 6-month period, then the provisions of paragraph (a) of this section shall apply to such credit or refund.

(c) The period within which a claim for credit or refund may be filed, or credit or refund allowed or made if no claim is filed, shall not expire before two years after the time the tax was paid, but if a claim is filed, or credit or refund allowed or made if no claim is filed, more than six months after the expiration of the period within which the Commissioner may make an assessment pursuant to such agreement or any extension thereof, the amount of the credit or refund shall not exceed the portion of the tax paid during the two years immediately preceeding the filing of the claim, or, if no claim is filed, immediately preceding the allowance of the credit or refund.

(d) If a claim for credit or refund is filed or if credit or refund is allowed or made before the execution of any agreement between the Commissioner and the taxpayer to extend the period within which the Commissioner might make an assessment, the limitations on such credit or refund shall be those specified in § 39.322-7.

(e) The agreement referred to in this section will not be considered to have been executed until the date it is signed by or for the Commissioner.

§ 39.322-9 *Limitations upon crediting and refunding of taxes paid, overpayment on account of bad debts, worthless securities, etc.* (a) (1) If the claim for credit or refund relates to an overpayment on account of—

(i) The deductibility by the taxpayer, under section 23 (k) (1) section 23 (k) (4) or section 204 (c), of a debt as a debt which became worthless, or, under section 23 (g) (2) or (k) (2), of a loss from the worthlessness of a security, or

(ii) The effect that the deductibility of a debt or loss described in subparagraph (1) of this paragraph has on the application to the taxpayer of a capital loss carry-over provided in section 117 (e), a net operating loss carry-over provided in section 122 (b), or an unused excess profits credit carry-over provided in section 432 (c)

then in lieu of the 3-year period from the date the return was filed in which claim may be filed or credit or refund allowed or made, as prescribed in § 39.322-7, the period shall be seven years from the date prescribed by law for filing the return (determined without regard to any extension of time for filing such return) for the taxable year for which the claim is made or the credit or refund allowed or made.

(2) If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of a debt or loss described in subparagraph (1) of this paragraph, has on the application to the taxpayer of a net operating loss carry-back provided in section 122 (b) or an unused excess profits credit carry-back provided in section 432 (c) such period shall be whichever of the following two periods expires later:

(i) Seven years from the date prescribed by law for filing the return (determined without regard to any extension of time for filing such return) for

the taxable year of the net operating loss or the unused excess profits credit; or

(ii) The period prescribed in § 39.322-11.

(3) In the case of any claim described in this section, the amount of the credit or refund may exceed the portion of the tax paid within the period provided in § 39.322-7 or § 39.322-8, whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of items described in this section. Such a credit or refund cannot exceed the sum of the following:

(i) The portion, if any, of the tax paid within the period provided in § 39.322-7 or § 39.322-8, whichever is applicable, and

(ii) The amount of overpayment due to the deductibility of items described in this section.

(4) The portion of an overpayment due to items described in this section shall be determined by treating the proper deduction of such items as the first adjustment to be made in computing such overpayment.

(b) If claim for credit or refund is not filed within the applicable period described in paragraph (a) of this section, then credit or refund may be allowed or made only if claim therefor is filed or if such credit or refund is allowed or made, within any period prescribed in § 39.322-7 or § 39.322-8, whichever is applicable, subject to the provisions thereof limiting the amount of credit or refund in the case of a claim filed, or, if no claim was filed, in the case of credit or refund allowed or made within such applicable period as prescribed in § 39.322-7 or § 39.322-8.

(c) The provisions of section 322 (b) (5) do not apply to an overpayment due to the deductibility of a debt that became partially worthless during the taxable year, but only to an overpayment due to the deductibility of a debt which became entirely worthless during such year.

(d) The provisions of paragraph (a) of this section with regard to an overpayment caused by the deductibility of a bad debt under section 23 (k) (1) section 23 (k) (4) or section 204 (c) or of a loss from the worthlessness of a security under section 23 (g) (2) or (k) (2) are likewise applicable to an overpayment caused by the effect that the deductibility of such a bad debt or loss has on the application to the taxpayer of a carry-over or of a carry-back.

(e) For the limitation on the allowance of interest for an overpayment where credit or refund is subject to the provisions of section 322 (b) (5) see section 3771 (d)

§ 39.322-10 *Limitations upon crediting and refunding of taxes paid, overpayment determined by the Tax Court.* (a) In any case where a person having a right to file a petition with The Tax Court of the United States with respect to a deficiency in income tax imposed by chapter 1 filed 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, subject to the following exceptions:

(1) If the Tax Court finds that the person has overpaid his tax for the year to which the notice of deficiency relates, and the decision of the Tax Court as to the amount overpaid has become final (see section 1140, Internal Revenue Code) the overpayment shall be credited or refunded, but no such credit or refund shall be made of any portion of the tax unless the Tax Court determines as part of its decision—

(i) That such portion was paid—

(*a*) Within two years immediately preceding the filing of a claim for credit or refund thereof, the mailing of the notice of deficiency, or the execution of an agreement by both the Commissioner and the taxpayer pursuant to section 276 (b) to extend beyond the time prescribed in section 275 the time within which the Commissioner might assess the tax, whichever event occurs first in point of time, or

(*b*) Within three years immediately preceding the filing of the claim, the mailing of the notice of deficiency, or the execution of the agreement, whichever event occurs first in point of time, if the claim was filed, the notice of deficiency mailed, or the agreement executed within three years from the time the return was filed by the taxpayer, or

(*c*) After the execution of such an agreement and before the expiration of the period within which the Commissioner might make an assessment pursuant to such agreement or any extension thereof, or

(*d*) After the mailing of the notice of deficiency or

(ii) If such portion of the tax was not paid within the period described in subdivision (i) of this subparagraph, but the notice of deficiency was mailed within seven years from the time prescribed for filing the return (determined without regard to any extension of time for filing such return), or a claim of the type described in § 39.322-9 was filed, that such portion of the tax does not exceed the amount of the overpayment attributable to the deductibility of items described in § 39.322-9, or

(iii) If such portion of the tax was not paid within the period described in subdivision (i) of this subparagraph, but the notice of deficiency was mailed within the period prescribed in § 39.322-11 for the filing of a claim for credit or refund of an overpayment attributable to a net operating loss carry-back or an unused excess profits credit carry-back, or such a claim was filed, that such portion of the tax does not exceed the amount of the overpayment attributable to the carry-back.

The amount of the overpayment attributable to the deductibility of items described in § 39.322-9 or to a carry-back shall be determined under the provisions of §§ 39.322-9 and 39.322-11, respectively. For the limitation on the allowance of interest for any portion of an overpayment described in subdivision (ii) or (iii) of this subparagraph, see section 3771 (d) or (e) whichever is applicable.

(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 Tax Court 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 Tax Court with respect to the time of payment as stated in paragraph (a) of this section.

(3) If the amount of the deficiency determined by the Tax Court (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 Tax Court with respect to the time of payment as stated in paragraph (a) of this section. See section 1146, Internal Revenue Code.

(4) Where the amount collected is in excess of the amount computed in accordance with the decision of The Tax Court 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 § 39.275-2), 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 Tax Court 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.

(b) For special provisions in the case of an overpayment resulting from the application of section 127 (c) (3) (relating to war loss recoveries) see section 127 (c) (5) and the regulations thereunder.

§ 39.322-11 *Limitations upon crediting and refunding of taxes paid—overpayment on account of net operating loss carry-backs and unused excess profits credit carry-backs—*(a) *Special period of limitation.* (1) If the claim for credit or refund relates to an overpayment attributable to a net operating loss carry-back, provided in section 122 (b), or to an unused excess profits credit carry-back, provided in section 432 (c) then in lieu of the 3-year period from the date the return was filed in which the claim may be filed or credit or refund allowed or made, as prescribed in § 39.322-7, the period shall be whichever of the following two periods expires later:

(i) The period which ends with the expiration of the fifteenth day of the thirty-ninth month following the end of the taxable year of the net operating loss which resulted in the carry-back; or

(ii) The period which ends with the expiration of the period prescribed in § 39.322-8 within which a claim for credit or refund may be filed with respect to the taxable year of the net operating loss which resulted in the carry-back.

(2) In the case of a claim described in subdivision (i) of this paragraph, the amount of the credit or refund may exceed the portion of the tax paid within the period prescribed in § 39.322-7 or § 39.322-8, whichever is applicable, to the extent of the amount of the overpayment attributable to the carry-back. Such a credit or refund cannot exceed the sum of the following:

(i) The portion, if any, of the tax paid within the period provided in § 39.322-7 or § 39.322-8, whichever is applicable, and

(ii) The amount of the overpayment attributable to the carry-back.

(3) The portion of an overpayment attributable to a carry-back shall be determined by treating the net operating loss deduction and the unused excess profits credit adjustment, to the extent that they are increased by the net operating loss carry-back or the unused excess profits credit carry-back, as the first adjustments to be made in computing such overpayment. If claim for credit or refund is not filed, and if credit or refund is not allowed or made, within the period described in this paragraph, then credit or refund may be allowed or made only if claim therefor is filed, or if such credit or refund is allowed or made, within any period prescribed in § 39.322-7 or § 39.322-8, whichever is applicable, subject to the provisions thereof limiting the amount of credit or refund in the case of a claim filed, or if no claim was filed, in case of credit or refund allowed or made within such applicable period. For the limitation on the allowance of interest for an overpayment where credit or refund is subject to the provisions of section 322 (b) (6) see section 3771 (e)

(b) *Barred overpayments.* If the allowance of a credit or refund of an overpayment of tax attributable to a net operating loss carry-back or to an unused excess profits credit carry-back is otherwise prevented by the operation of any law or rule of law (other than section 3761, relating to compromises) such credit or refund may be allowed or made under the provisions of section 322 (g) if a claim therefor is filed within the period provided by section 322 (b) (6) and paragraph (a) of this section for filing a claim for credit or refund of an overpayment attributable to a carry-back. Similarly, if the allowance of an application, credit, or refund of a decrease in tax determined under section 3780 (b) is otherwise prevented by the operation of any law or rule of law (other than section 3761) such application, credit, or refund may be allowed or made if an application for a tentative carry-back adjustment is filed within the period provided in section 3780 (a) Thus, for example, even though the tax liability for a given taxable year has previously been litigated before The Tax Court of the United States, credit or refund of an overpayment may be allowed or made despite the provisions of section 322 (c) if claim for such credit or refund is filed within the period provided in section 322 (b) (6) and paragraph (a) of this section. In the case of a claim for credit or refund of an overpayment attributable to a carry-back, or in the case of an application for a tentative carry-back adjustment, the determination of any court, including The Tax Court of the United States in any proceeding in which the decision of the court has become final, shall be conclusive except with respect to the net operating loss deduction and the unused excess profits credit adjustment, and the effect of such deduction or adjustment, to the extent that such deduction or adjustment is affected by a carry-back which was not in issue in such proceeding.

§ 39.322-12 *Crediting of accounts of district directors 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 district director of internal revenue from liability under section 3950, 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.

SUPPLEMENT P—FOREIGN PERSONAL HOLDING COMPANIES

§ 39.331 *Statutory provisions; definition of foreign personal holding company.*

SEC. 331. *Definition of foreign personal holding company*—(a) *General rule.* For the purposes of this chapter 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.

§ 39.331-1 *Definition of foreign personal holding company.* (a) 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 (1) the gross income requirement specified in § 39.331-2, and (2) the stock ownership requirement specified in § 39.331-3. Both requirements must be satisfied and both must be met with respect to each taxable year.

(b) A foreign corporation which comes within the classification of a foreign personal holding company is not subject to taxation either under section 102 or section 500. 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.

§ 39.331-2 *Gross income requirement.* (a) 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 section 334 (b) as required by section 334 (c) (2)) be foreign personal holding company income as defined in section 332:

(1) Sixty percent or more; or

(2) Fifty 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—

(i) 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

(ii) 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.

(b) 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 §§ 39.22 (a)-1 to 39.22 (a)-23, inclusive.

§ 39.331-3 *Stock ownership requirement.* (a) 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

§ 39.333 (a)-1 to 39.333 (a)-7, inclusive, and § 39.333 (b)-1.

(b) 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.

(c) 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.

§ 39.332 *Statutory provisions; foreign personal holding company income.*

SEC. 332. *Foreign personal holding company income.* For the purposes of this chapter 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).

§ 39.332-1. *Foreign personal holding company income.* For the purposes of Supplement P (sections 331 to 340, inclusive) and of §§ 39.331-1 to 39.339-3, inclusive, the term "foreign personal holding company income" means the portion of the gross income determined for the purposes of section 331 (a) (1) and § 39.331-2 which consists of the following:

(a) *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) See § 39.115 (a)-1.

(b) *Interest.* The term "interest" means any amounts, includible in gross income, received for the use of money loaned.

(c) *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.

(d) *Annuities.* The term "annuities" includes annuities only to the extent includible in the computation of gross income. See section 22 (b) (2)

(e) *Gains from the sale or exchange of stock or securities.* As used in section 332 (b) the term "gains from the sale or exchange of stock or securities" 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. As used in section 332 (b) the term "stock or securities" 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 Internal Revenue Code) 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, equipment trust certificates, bills of exchange, and 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. As used in section 332 (b) the term "regular dealers 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.

(f) *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.

(g) *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, inclusive, together with the gains derived by the corporation from the sale or other disposition of any interest in an estate or trust.

(h) *Amounts received under personal service contracts.* (1) 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—

(i) 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

(ii) 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 §§ 39.333 (a)-1 to 39.333 (a)-7, inclusive, and § 39.333 (b)-1.

(2) The application of section 332 (e) and this paragraph 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.

(i) *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 §§ 39.333 (a)-1 to 39,333 (a)-7, inclusive, and § 39.333 (b)-1.

(j) *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 (i) of this section. However, rents do not constitute foreign personal holding company income if constituting 50 percent or more of the gross income of the corporation.

§ 39.333 (a) *Statutory provisions; foreign personal holding companies; constructive stock-ownership rules.*

SEC. 333. *Stock ownership.* (a) *Constructive ownership.* For the purpose of determining whether a foreign corporation is a foreign personal holding company, in so far 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).

§ 39.333 (a)-1 *Stock ownership* (a) For the purpose of determining whether—

(1) A foreign corporation is a foreign personal holding company, insofar as such determination is based on the stock ownership requirements specified in section 331 (a) (2) and § 39.331-3, or

(2) Amounts received under a personal service contract or from the sale of such a contract constitute foreign personal holding company income insofar as such determination is based on the stock ownership requirement specified in section 332 (e) and paragraph (h) of § 39.332-1, or

(3) Compensation for the use of property constitutes foreign personal holding company income insofar as such determination is based on the stock ownership requirement specified in section 332 (f) and paragraph (i) of § 39.332-1,

stock owned by an individual includes stock constructively owned by him as provided in section 333.

(b) For the purposes of paragraph (a) of this section, constructive ownership of stock shall be determined and applied in accordance with the rules provided in section 333 and §§ 39.333 (a)-2 to 39.333 (a)-7, inclusive, and § 39.333 (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.

§ 39.333 (a)-2 *Stock not owned by individual.* In determining the ownership of stock for any of the purposes set forth in § 39.333 (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 § 39.333 (a)-6.

§ 39.333 (a)-3 *Family and partnership ownership.* (a) In determining the ownership of stock for any of the purposes set forth in § 39.333 (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.

(b) The application of the family and partnership rule in determining the ownership of stock for the purpose set forth in paragraph (a) (1) of § 39.333 (a)-1 is illustrated by the following example:

Example. (1) 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	100	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								

(2) 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

(3) 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.

(c) 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 paragraphs (a) (2) and (3) of § 39.333 (a)-1.

§ 39.333 (a)-4 *Options.* In determining the ownership of stock for any of the purposes set forth in § 39.333 (a)-1, if any person has an option to acquire stock, such stock may be considered as owned by such person. As used in this section, the term "option" 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.

§ 39.333 (a)-5 *Application of family and partnership rule and option rule.* (a) The family and partnership rule provided in section 333 (a) (2) and § 39.333 (a)-3 and the option rule provided in section 333 (a) (3) and § 39.333 (a)-4 shall be applied—

(1) For the purpose stated in paragraph (a) (1) of § 39.333 (a)-1, if, but only if, the effect of such application is to make the foreign corporation a foreign personal holding company, or

(2) For the purpose stated in paragraph (a) (2) of § 39.333 (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

(3) For the purpose stated in paragraph (a) (3) of § 39.333 (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.

(b) The family and partnership rule and the option rule must be applied independently for each of the purposes stated in § 39.333 (a)-1.

§ 39.333 (a)-6 *Constructive ownership as actual ownership.* (a) In determining the ownership of stock for any of the purposes set forth in § 39.333 (a)-1—

(1) 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 § 39.333 (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 § 39.333 (a)-3) in order to make another person the constructive owner of such stock, and

(2) Stock constructively owned by a person by reason of the application of the option rule provided in section 333 (a) (3) (see § 39.333 (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

(3) 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.

(b) The application of paragraph (a) of this section 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 § 39.333 (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.

§ 39.333 (a)-7 *Option rule in lieu of family and partnership rule.* (a) If, in determining the ownership of stock for any of the purposes set forth in § 39.333 (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 § 39.333 (a)-3) and the option rule provided in section 333 (a) (3) (see § 39.333 (a)-4) such stock shall be considered as owned constructively by the individual by reason of the application of the option rule.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. (1) 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 § 39.333 (a)-1, to determine the stock ownership of B in the M Corporation.

(2) 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 (i) AW is not a member of B's family and (ii) 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 § 39.333 (a)–6.)

(3) 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 § 39.333 (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.

§ 39.333 (b) *Statutory provisions; foreign personal holding companies; constructive stock-ownership rules; convertible securities.*

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.

§ 39.333 (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 1952, 1953, and 1954, those convertible in 1952 can be properly considered as outstanding stock without so considering those convertible in 1953 or 1954, and those convertible in 1952 and 1953 can be properly considered as outstanding stock without so considering those convertible in 1954. However, the securities convertible in 1953 could not be properly considered as outstanding stock without so considering those convertible in 1952 and the securities convertible in 1954 could not be properly considered as outstanding stock without so considering those convertible in 1952 and 1953.

§ 39.334 *Statutory provisions; gross income of foreign personal holding companies.*

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, 1939) 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).

§ 39.334–1 *Gross income in general for purposes of Supplement P* For all purposes of Supplement P (sections 331 to 340, inclusive) and of §§ 39.331–1 to 39.339–3, inclusive, 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 (sections 231 to 238, inclusive) and §§ 39.231–1 to 39.236–1, inclusive, 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 regulations thereunder. The gross income thus includes the interest on bonds 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 (31 U. S. C. 750)

§ 39.334–2 *Additions to gross income for purposes of Supplement P* (a) If, for any taxable year—

(1) A foreign corporation meets the stock ownership requirement specified in § 39.331–3, regardless of whatever day in its taxable year is the last day on which the required United States group exists, and

(2) Such foreign corporation is a shareholder in a foreign personal holding company on any day of a taxable year 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—

(3) Determining whether the first company meets the gross income requirement specified in § 39.331–2, so as to come within the classification of a foreign personal holding company, and

(4) 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 divi-

dend, if on the last day referred to in subparagraph (2) of this paragraph 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.

(b) The application of paragraph (a) of this section 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, 1953, 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, 1953. The X Corporation meets the stock ownership requirement and constitutes a foreign personal holding company for 1953, 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, 1953, must be included as a dividend in the gross income of the X Corporation for 1953, since—

(1) The X Corporation was a shareholder in the Y Corporation on a day (June 30, 1953) 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,

(2) 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

(3) The X Corporation being the sole shareholder of the Y Corporation must include such portion in its gross income for 1953, 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 1953*, 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, 1953, so that after that date no United States group existed with respect to the Y Corporation. For the fiscal year ending June 30, 1954, 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, 1953. 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, 1954, since at one time in such fiscal year, or from July 1 to and including September 30, 1953, 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 1954, a portion of the undistributed Supplement P net income of the Y Corporation for the fiscal year ending June 30, 1954 (3/12 of $100,000, or $25,000), must be included as a dividend in the gross income of the X Corporation, since—

(1) The X Corporation was a shareholder in the Y Corporation on September 30, 1953, 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,

(2) 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

(3) 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 1954, 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, 1953, 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, 1953, 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, 1954, 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 1954, 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, 1953, 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 80 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.

§ 39.335–336 *Statutory provisions; foreign personal holding companies; undistributed Supplement P net income; Supplement P net income.*

SEC. 335. *Undistributed Supplement P net income.* For the purposes of this chapter 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 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).

SEC. 336. *Supplement P net income.* For the purposes of this chapter 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 includ-

ing the tax imposed by section 102, section 500, 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). For the purposes of the preceding sentence, payment of any contribution or gift shall be considered as made within the taxable year if and only if it is considered for the purposes of section 23 (q) as made within such year.

(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.

(3) *Net loss carry-over disallowed.* The deduction for net operating losses provided in section 23 (s) shall not be allowed.

(c) [Not applicable to taxable years beginning after December 31, 1951.]

(d) *Income not placed on annual basis.* The net income shall be computed without regard to section 47 (c).

[Sec. 336 as amended by secs. 211 (g) and 212 (c), Rev. Act 1939; secs. 135 (b) (2) and 150 (h), Rev. Act 1942; sec. 3 (b), Pub. Law 378 (81st Cong.)]

§ 39.336–1 *Supplement P net income.* (a) 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 (sections 231 to 238, inclusive)) subject to the qualifications, limitations, and exceptions provided in section 336. In the case of a taxable year of less than 12 months on account of a change in the accounting period of the corporation, the net income as so computed is not placed on an annual basis under section 47 (c) In addition to the qualifications, limitations, and exceptions provided in sections 336 (a) and 336 (b) (1) a foreign personal holding company is subject to the provisions of sections 336 (b) (2) and 336 (b) (3) in the computation of its Supplement P net income. Section 336 (b) (3) provides that the net operating loss deduction provided by section 23 (s) shall not be allowed. 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.

(b) 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 § 39.337–1) 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:

(1) A description of the property;

(2) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(3) The name and address of the person from whom acquired and the date thereof;

(4) 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;

(5) 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;

(6) Evidence that the rent or other compensation was the highest obtainable or, if none was received, a statement of the reasons therefor;

(7) A copy of the contract, lease, or rental agreement;

(8) The purpose for which the property was used;

(9) 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;

(10) 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

(11) Any other information pertinent to the taxpayer's claim.

§ 39.336–2 *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 by the following example:

Example. (a) The following facts exist with respect to the M Corporation, a foreign personal holding company, for the calendar year 1952:

(1) 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.

(2) The expenses of the corporation amount to $85,000, of which $75,000 is allocable to the maintenance and operation of the property used by the principal shareholder and $10,000 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.

(3) Federal income tax withheld at the source on the income of the corporation from sources within the United States amounts to $59,125.

(4) 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. Such losses are not allowed as a deduction in any amount under the provisions of section 117.

(5) 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.

(6) Dividends paid by the corporation to its shareholders during the taxable year amount to $50,000.

(b) 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)	10,000	
Contributions (within the 5 percent limitation specified in sec. 23 (q))	5,000	
		120,000
Net income for purposes of computing Supplement P net income		180,000

(c) The Supplement P net income and the undistributed Supplement P net income of the corporation are $210,875 and $160,875, respectively, computed as follows:

Net income for purposes of computing Supplement P net income		$180,000
Add (see sec. 336 (b))		
Contributions deductible in computing net income under sec. 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	$59,125	
Contributions (within the 15 percent limitation specified in sec. 336 (a) (2))	15,000	
	74,125	
Net additions under section 336		30,875
Supplement P net income		210,875
Less:		
Basic surtax credit for dividends paid (see sec. 335)		50,000
Undistributed Supplement P net income		160,875

§ 39.337 *Statutory provisions; foreign personal holding companies; income taxed to United States shareholders.*

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 chapter 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 section 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). If the foreign personal holding company elects under section 125 to treat the premium on bonds, the interest on which is allowable as a credit under section 25 (a) (1) or (2), as amortizable, for the purposes of the preceding sentence each United States shareholder's proportionate share of such interest received by the foreign personal holding company shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 23 (v) as is attributable to such share.

(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), to 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).

[Sec. 337 as amended by sec. 126 (g), Rev. Act 1942]

§ 39.337-1 *Income of foreign personal holding companies taxed to United States shareholders*—(a) *General rule.* Supplement P (sections 331 to 340, inclusive) 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 section, 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 3797 (a)) and estates or trusts other than estates or trusts the gross income of which under chapter 1 includes only income from sources within the United States.

(b) *Amount includible in gross income.* (1) 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 § 39.331-3) 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.

(2) 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 cannot be included within the United States group since, under section 333 (a) (1) and § 39.333 (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.

(3) 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 percent 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.

(4) 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.

(5) 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 1952, 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 1952, and B must return his distributive share as income for the fiscal year ending November 30, 1953. 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, 1952, 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, 1953, even though September 30, 1952, the date as of which the distribution is assumed to have been made, does not fall within such fiscal year.

§ 39.337-2 *Credit for obligations of the United States.* (a) 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 section 11, 13, 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 § 39.334-2. For reduction of credit for such interest on account of amortizable bond premium, see § 39.125 (c)-2.

(b) The rule set forth in paragraph (a) of this section may be illustrated by the following example:

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).

§ 39.337-3 *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 Internal Revenue Code of such persons, in the form of a statement attached to the return.

§ 39.337-4 *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 such 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 percent, of its stock is owned by B, a nonresident alien individual. For the calendar year 1952 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 1952. 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 1952 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 1952, and if for the calendar year 1953, 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 1952, the facts otherwise being the same, the distributions in 1953 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 1952, $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 Internal Revenue Code 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.

§ 39.338 *Statutory provisions; foreign personal holding companies; information returns by officers and directors.*

SEC. 338. *Information returns by officers and directors*—(a) *Monthly returns.* On the fifteenth day of each month each individual who on such day is an officer or a director of a foreign corporation which, with respect to its taxable year preceding the taxable year (whether beginning on, before, or after January 1, 1939) 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 title. 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 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.

§ 39.338-1 *Information returns by officers and directors of certain foreign corporations*—(a) *Requirement for filing returns*—(1) *General.* Under section 338 (a) on the fifteenth day of each month each individual who on such day is an officer or a director of a foreign corporation which, with respect to its taxable year preceding the taxable year in which such month occurs, was a foreign personal holding company, is required to file a monthly information return as provided in section 338 (a) and this section.

(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 distributed to its shareholders 90 percent or more of its Supplement P net income as defined in section 336, 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:

(i) The return for the last month of the preceding taxable year shall be filed on the fifteenth day of the first month following the close of such taxable year.

(ii) Subsequent returns shall be filed for each 6-month period following the close of such taxable year and shall be filed on the fifteenth day of the first month following such period.

(iii) 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 fifteenth day of the month following each month in which the change occurs or the resolution or plan is adopted.

(iv) In any case under this subparagraph, 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.

(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 section, 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 section shall be made on Form 957, copies of which, upon request, may be procured from any district director of internal revenue. Each officer or director of the corporation 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 Internal Revenue Code.

(c) *Contents of return.* The return shall, in accordance with the provisions of this section 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.

(d) *Separate return for each corporation.* If a person is required to file a return under section 338 (a) and this section with respect to more than one foreign corporation, a separate return must be filed with respect to each foreign corporation.

(e) *Verification of returns.* Every return required by section 338 (a) and this section shall be verified by a written declaration that it is made under the penalties of perjury.

(f) *Penalties.* For criminal penalties for failure to file the returns required by section 338 (a) and this section, see section 340.

§ 39.338-2 *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 an annual information return as provided in section 338 (b) and this section.

(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 section 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 section shall be made on Form 958, copies of which, upon request, may be procured from any district director of internal revenue. Each officer or director of the corporation 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 Internal Revenue Code.

(c) *Contents of return.* The return shall, in accordance with the provisions of this section 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 § 39.338-1, except that if all the required returns with respect to such year have been filed under section 338 (a) and § 39.338-1, 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.* Every return required by section 338 (b) and this section shall be verified by a written declaration that it is made under the penalties of perjury.

(e) *Penalties.* For criminal penalties for failure to file the returns required by section 338 (b) and this section, see section 340.

§ 39.338-3 *Time and place of filing returns.* Returns required by section 338 and §§ 39.338-1 and 39.338-2 shall be filed with the Commissioner of Internal Revenue, Washington 25, D. C., attention Audit Service Branch, Audit 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.

§ 39.339 *Statutory provisions; foreign personal holding companies; information returns by shareholders.*

SEC. 339. *Information returns by shareholders*—(a) *Monthly returns.* On the fifteenth day of each month 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 preceding the taxable year (whether beginning on, before, or after January 1, 1939) 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 title. 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.

§ 39.339-1 *Information returns by shareholders of certain foreign corporations*—(a) *Requirement for filing returns*—(1) *General.* On the fifteenth day of each month 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 preceding the taxable year in which such month occurs was a foreign personal holding company, shall file an information return as provided in section 339 (a) and this section.

(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 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 § 39.338-1.

(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 § 39.338-1, such returns shall be considered as returns filed under section 339 (a)

(b) *Form of return.* The return under section 339 (a) and this section shall be made on Form 957, copies of which, upon request, may be procured from any district director of internal revenue. 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 Internal Revenue Code.

(c) *Contents of return.* The return shall, in accordance with the provisions of this section 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 § 39.338-1.

(d) *Separate return for each corporation.* If a person is required to file a return under section 339 (a) and this section with respect to more than one foreign corporation, a separate return must be filed with respect to each foreign corporation.

(e) *Verification of returns.* Every return required by section 339 (a) and this section shall be verified by a written declaration that it is made under the penalties of perjury.

(f) *Penalties.* For criminal penalties for failure to file the returns required by section 339 (a) and this section, see section 340.

§ 39.339-2 *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 for 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 an information return as provided in section 339 (b) and this section.

(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 § 39.338-2, such returns shall be considered as returns filed under section 339 (b)

(b) *Form of return.* The return under section 339 (b) and this section shall be made on Form 957, copies of which, upon request, may be procured from any district director of internal revenue. 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 Internal Revenue Code.

(c) *Contents of return.* The return shall, in accordance with the provisions of this section 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 § 39.338-1, and paragraph (c) of § 39.339-1, except that if all the required returns with respect to such year have been filed under section 339 (a) and § 39.339-1, no return under section 339 (b) and this section is required.

(d) *Separate return for each corporation.* If a person is required to file an annual return under section 339 (b) and this section with respect to more than one foreign personal holding company, a separate return must be filed with respect to each foreign personal holding company.

(e) *Verification of returns.* Every return required by section 339 (b) and this section shall be verified by a written declaration that it is made under the penalties of perjury.

(f) *Penalties.* For criminal penalties for failure to file the returns required by section 339 (b) and this section, see section 340.

§ 39.339-3 *Time and place of filing returns.* Returns required by section 339 and §§ 39.339-1 and 39.339-2 shall be filed with the Commissioner of Internal Revenue, Washington 25, D. C., attention Audit Service Branch, Audit 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.

§ 39.340 *Statutory provisions; foreign personal holding companies; penalties.*

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.

SUPPLEMENT Q—REGULATED INVESTMENT COMPANIES

§ 39.361 *Statutory provisions; definition of regulated investment company.*

SEC. 361. *Definition*—(a) *In general.* For the purposes of this chapter, the term "regulated investment company" means any domestic corporation (whether charted or created as an investment trust, or otherwise), other than a personal holding company as defined in section 501, which at all times during the taxable year is registered under the Investment Company Act of 1940 (54 Stat. 789, 15 U. S. C., 1940 ed., secs. 80 a-1 to 80 b-2), or that act, as amended, either as a management company or as a unit investment trust, or which is a common trust fund or similar fund excluded by section 3 (c) (3) of such act from the definition of "investment company" and is not included in the definition of "common trust fund" by section 169.

(b) *Limitations.* Despite the provisions of subsection (a), a corporation shall not be considered a regulated investment company for any taxable year unless—

(1) At least 90 per centum of its gross income is derived from dividends, interest, and gains from the sale or other disposition of stock or securities; and

(2) 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 three months; and

(3) At the close of each quarter of the taxable year (A) at least 50 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other regulated investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of the taxpayer and, except and to the extent provided in subsection (c), to not more than 10 per centum of the outstanding voting securities of such issuer, and (B) not more than 25 per centum of the value of its total assets is invested in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Commissioner with the approval of the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses. For the purposes of clause (B), in ascertaining the value of the taxpayer's investment in the securities of an issuer, there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer, as determined under regulations prescribed by the Commissioner and approved by the Secretary. The term "controls," as used in this paragraph, means the ownership in a corporation of 20 per centum or more of the total combined voting power of all classes of stock entitled to vote. The term "controlled group," as used in this paragraph, means one or more chains of corporations connected through stock ownership with the taxpayer if (i) 20 per centum or more of the total combined voting power of all classes of stock entitled to vote of each of the corporations (except the taxpayer) is owned directly by one or more of the other corporations, and (ii) the taxpayer owns directly 20 per centum or more of the total combined voting power of all classes of stock entitled to vote, or at least one of the other corporations. The term "value" as used in this paragraph means, with respect to securities (other than those of majority-owned subsidiaries) for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the board of directors, except that in the case of securities of majority-owned subsidiaries which are investment companies such fair value shall not exceed market value or asset value, whichever is higher. All other terms used in the preceding provisions of this paragraph shall have the same meaning as when used in the Investment Company Act of 1940, or that Act as amended. A corporation which meets the foregoing requirements of this paragraph at the close of any quarter shall not lose its status as a regulated investment company because of a discrepancy during a subsequent quarter between the value of its various investments and such requirements unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. A corporation which does not meet such requirements at the close of any quarter by reason of a discrepancy existing immediately after the acquisition of any security or other property which is wholly or partly the result of such acquisition during such quarter shall not lose its status for such quarter as a regulated investment company if such discrepancy is eliminated within thirty days after the close of such quarter and in such cases it shall be considered to have met such requirements at the close of such quarter for the purposes of applying the preceding sentence. A corporation which meets such requirements at the close of its first full quarter after the date of the enactment of the Revenue Act of 1942, or eliminates any discrepancy between the value of its investments and such requirements existing at the close of such quarter within thirty days thereafter, shall be deemed to have met such requirements at all previous times; and

(4) It files with its return for the taxable year an election to be a regulated investment company or has made such election for a previous taxable year which began after December 31, 1941.

(c) *Certain investment companies.* If the Securities and Exchange Commission determines in accordance with regulations issued by it, and certifies to the Secretary not more than 60 days prior to the close of the taxable year of a registered management investment company, that such investment company is principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, such investment company may, in the computation of 50 per centum of the value of its assets under subparagraph (A) of subsection (b) (3) for any quarter of such taxable year, include the value of any securities of an issuer, notwithstanding the fact that such investment company holds more than 10 per centum of the outstanding voting securities of such issuer, but only if the investment company has not continuously held any security of such issuer (or of any predecessor company of such issuer as determined under regulations prescribed by the Secretary) for 10 or more years preceding such quarter of such taxable year. The provisions of this subsection shall not apply at the close of any quarter of a taxable year to an investment company if at the close of such quarter more than 25 per centum of the value of its total assets is represented by securities of issuers with respect to each of which the investment company holds more than 10 per centum of the outstanding voting securities of such issuer and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 10 or more years preceding such quarter unless the value of its total assets so represented is reduced to 25 per centum or less within 30 days after the close of such quarter. The terms used in this subsection shall have the same meaning as in subsection (b) (3) of this section. For the purposes of this subsection, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years prior to such date it has acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or predecessor thereof. For the purposes of the certification hereunder, the Securities and Exchange Commission shall have authority to issue such rules, regulations and orders, and to conduct such investigations and hearings, either public or private, as it may deem appropriate.

[Sec. 361 as amended by sec. 170 (a), Rev. Act 1942; sec. 337, Rev. Act 1951]

§ 39.361-1 *Definition of a regulated investment company*—(a) *Limitations upon source of income.* Section 361 (b) (1) and (2) provides that at least 90 percent of the corporation's gross income for the taxable year must be derived from dividends, interest, and gains from the sale or other disposition of stocks or securities, and less than 30 percent of the corporation's gross income must have been derived from the sale or other disposition of stock or securities held for less than three months. As to the definition of the term "corporation," see section 3797 (a) (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. A 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.

(b) *Limitations requiring diversification of investments*—(1) *In general.* (i) Section 361 (b) (3), with respect to diversification of investments, requires, in clause (A), that at the close of each quarter of the taxable year at least 50 percent of the value of the total assets

of the corporation be represented by cash and cash items (including receivables) Government securities, securities of other regulated investment companies, and other securities. For the purpose of this calculation, investments in securities other than Government securities or securities of other regulated investment companies shall be limited in respect of any one issuer to an amount not greater than 5 percent of the value of the total assets of the corporation and, except and to the extent provided in section 361 (c) in the case of certain venture capital registered management investment companies qualifying thereunder, to not more than 10 percent of the outstanding voting securities of such issuer. Assuming that at least 50 percent of the value of the total assets of the corporation satisfies these requirements, and that the limiting provisions of clause (B) are not violated, the corporation will satisfy the requirements of section 361 (b) (3) notwithstanding that the remaining assets do not satisfy the diversification requirements of clause (A) For example, a corporation may own all the stock of another corporation, provided it otherwise meets the requirements of clauses (A) and (B)

(ii) Clause (B) prohibits the investment at the close of each quarter of the taxable year of more than 25 percent of the value of the total assets of the corporation (including the 50 percent or more mentioned in clause (A)) in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers, which the corporation controls and which are engaged in the same or similar trades or businesses or related trades or businesses, including such issuers that are merely a part of a unit contributing to the completion and sale of a product or the rendering of a particular service. Two or more issuers are not considered as being in the same or similar trades or businesses merely because they are engaged in the broad field of manufacturing or of any other general classification of industry but issuers shall be construed to be engaged in the same or similar trades or businesses if they are engaged in a distinct branch of business, trade, or manufacture in which they render the same kind of service or produce or deal in the same kind of product, and such service or products fulfill the same economic need. If two or more issuers produce more than one product or render more than one type of service, then the chief product or service of each shall be the basis for determining whether they are in the same trade or business. For the purposes of this paragraph, the terms "controls," "controlled group," and "value" are defined in section 361 (b) (3) All other terms used in this section have the same meaning as when used in the Investment Company Act of 1940 (15 U. S. C., c. 2D) or that act as amended. In determining the value of the investment company's investment in the securities of any one issuer, there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer. With respect to the effect which certain discrepancies between the value of its various investments and the requirements of section 361 (b) (3) or the elimination of such discrepancies will have on the status of a company as a regulated investment company for the purposes of these sections, see section 361 (b) (3) A company claiming to be a regulated investment company shall keep sufficient records as to investments so as to be able to show that it has complied with the provisions of section 361 (b) (3) during the taxable year. Such records shall be kept at all times available for inspection by any authorized officer or employee of the Internal Revenue Service and shall be retained as long as the contents thereof may become material in the administration of any internal revenue law.

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

Example (1). Investment Company W at the close of its first quarter of the taxable year has its assets invested as follows: 5 percent in cash, 10 percent in Government securities, 20 percent in the securities of regulated investment companies as defined in section 361, 10 percent in the securities of Corporation A, 15 percent in Corporation B, 20 percent in Corporation C, and the balance, 20 percent, in the securities of various corporations, not exceeding 5 percent of its assets in any one company. Investment Company W owns 15 percent of the voting stock of Corporation C and less than 10 percent of the voting stock of the other corporations, except that it owns all of the voting stock of Corporations A and B. None of the corporations is a member of a controlled group. Investment Company W meets the requirements at the end of its first quarter under section 361 (b) (3). It complies with clause (A) since it has 55 percent of its assets invested as provided in clause (A). It complies with clause (B) since it does not have more than 25 percent of its assets invested in the securities of any one issuer, or of two or more issuers which it controls.

Example (2). Investment Company V at the close of a particular quarter of the taxable year has its assets invested as follows: 10 percent in cash, 35 percent in Government securities, 7 percent in the securities of Corporation A, 12 percent in Corporation B, 15 percent in Corporation C, and 21 percent in Corporation D. Investment Company V fails to meet the requirements of clause (A) of section 361 (b) (3) since its assets invested in Corporations A, B, C, and D exceed in each case 5 percent of the value of the total assets of the company at the close of the particular quarter.

Example (3). Investment Company X at the close of the particular quarter of the taxable year has its assets invested as follows: 20 percent in cash and Government securities, 5 percent in Corporation A, 10 percent in Corporation B, 25 percent in Corporation C, and the other 40 percent in the securities of miscellaneous corporations, not exceeding 5 percent in any one issuer. Investment Company X owns less than 10 percent of the voting power of all of the corporations, except it owns more than 20 percent of the voting power of Corporations B and C. Corporation B manufactures radios and Corporation C acts as its distributor and also distributes radios for other companies. Investment Company X fails to meet the requirements of section 361 (b) (3) since it has 35 percent of its assets invested in the securities of two issuers which it controls and which are engaged in related trades or businesses.

Example (4). Investment Company Y at the close of the particular quarter has 15 percent of its assets invested in cash and Government securities, 30 percent in Corporation K, a regulated investment company, 10 percent in Corporation A, 20 percent in Corporation B, and the remaining 25 percent in various corporations in none of which is more than 5 percent of its assets invested. Corporation K has 20 percent of its assets invested in Corporation L, and Corporation L has 40 percent of its assets invested in Corporation B. Corporation A also has 30 percent of its assets invested in Corporation B, and owns more than 20 percent of the voting power in Corporation B. Investment Company Y owns more than 20 percent of the voting power of Corporations A and K. Corporation K owns more than 20 percent of the voting power of Corporation L, and Corporation L owns more than 20 percent of the voting power of Corporation B. Investment Company Y is disqualified under clause (B) since more than 25 percent of its assets is considered invested in Corporation B as shown by the following calculation:

	Percent
Percentage of assets invested directly in Corporation B	20.0
Percentage invested through the controlled group, Y-K-L-B (40 percent of 20 percent of 30 percent)	2.4
Percentage invested in the controlled group, Y-A-B (30 percent of 10 percent)	3.0
Total percentage of assets of Investment Company Y invested in Corporation B	25.4

Example (5). Investment Company Z, which keeps its books and makes its returns on the basis of the calendar year, at the close of the first quarter of 1952 meets the requirements of section 361 (b) (3) and has 20 percent of its assets invested in Corporation A. Later during the taxable year it makes distributions to its shareholders and because of such distributions it finds at the close of the taxable year that it has more than 25 percent of its remaining assets invested in Corporation A. Investment Company Z does not lose its status as a regulated investment company for the taxable year 1952 because of such distributions.

(2) *Venture capital registered management investment companies.* (i) Section 361 (c) provides that under certain conditions set forth below a registered management investment company which has been certified by the Securities and Exchange Commission for the taxable year may, in the computation of 50 percent of the value of its assets under clause (A) of section 361 (b) (3) for any quarter of such taxable year, include, with respect to securities other than Government securities or securities of other regulated investment companies, the value of any securities of an issuer, notwithstanding the fact that such registered management investment company holds more than 10 percent of the outstanding voting securities of such issuer, but only if the investment company has not continuously held any security of such issuer or of any predecessor company of such issuer for 10 or more years preceding such quarter of such taxable year. All other provisions and requirements of section 361 and the

regulations thereunder are applicable in determining whether such registered management investment company qualifies as a regulated investment company within the meaning of such section.

(ii) The provisions of section 361 (c) are applicable only to a registered management investment company which the Securities and Exchange Commission has determined, in accordance with regulations issued by it, and has certified to the Secretary, not more than 60 days before the close of the taxable year of such investment company, to be principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available. For the purpose of the aforementioned determination and certification, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years before such date it has acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or its predecessor.

(iii) Section 361 (c) does not apply in the quarterly computation of 50 percent of the value of the assets of an investment company under clause (A) of section 361 (b) (3) for any taxable year if at the close of any quarter of such taxable year more than 25 percent of the value of its total assets (including the 50 percent or more mentioned in such clause (A)) is represented by securities (other than Government securities or the securities of other regulated investment companies) of issuers as to each of which (*a*) such investment company holds more than 10 percent of the outstanding voting securities of such issuer and (*b*) such investment company has continuously held any security of such issuer (or any security of a predecessor of such issuer) for 10 or more years preceding such quarter, unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

(iv) As used in section 361 (c) and this subparagraph, the term "predecessor company" means any corporation the basis of whose securities in the hands of the investment company was, under the provisions of section 113, the same in whole or in part as the basis of any of the securities of the issuer and any corporation with respect to whose securities any of the securities of the issuer were received directly or indirectly by the investment company in a transaction or series of transactions involving nonrecognition of gain or loss in whole or in part. The other terms used in this subparagraph have the same meaning as when used in section 361 (b) (3). See subparagraph (1) of this paragraph.

(c) *Requirements as to election.* Even if an investment company satisfies the other requirements of section 361 for the taxable year, it will not be considered a regulated investment company for such year within the meaning of Supplement Q unless it elects to be a regulated investment company for such taxable year, or has made such an election for a previous taxable year. The election shall be made by the taxpayer by computing income as a regulated investment company in its return for the first taxable year to which it desires the election to be applicable. No other method of making such election is permitted. An election once made is irrevocable for the current taxable year and all succeeding taxable years.

§ 39.362 *Statutory provisions; tax on regulated investment companies.*

SEC. 362. *Tax on regulated investment companies*—(a) *Earnings and profits.* The earnings and profits of a regulated investment company for any taxable year beginning after December 31, 1941 (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its net income for such taxable year.

(b) *Method of taxation of companies and shareholders.* In the case of a regulated investment company which distributes during the taxable year to its shareholders as taxable dividends other than capital gain dividends an amount not less than 90 per centum of its net income for the taxable year computed without regard to net long-term and net short-term capital gains, and complies for such year with all rules and regulations prescribed by the Commissioner, with the approval of the Secretary, for the purpose of ascertaining the actual ownership of its outstanding stock:

(1) Its Supplement Q net income shall be its adjusted net income (computed by excluding the excess, if any, of the net long-term capital gain over the net short-term capital loss, and without the net operating loss deduction provided in section 23 (s)) minus the basic surtax credit (excluding capital gain dividends) computed under section 27 (b) without the application of paragraphs (2) and (3). For the purposes of this paragraph, the net income shall be computed without regard to section 47 (c).

(2) Its Supplement Q surtax net income shall be its net income (computed by excluding the excess, if any, of the net long-term capital gain over the net short-term capital loss, and without the net operating loss deduction provided in section 23 (s)) minus the dividends (other than capital gain dividends) paid during the taxable year increased by the consent dividends credit provided by section 28. For the purposes of this paragraph and paragraph (5) the amount of dividends paid shall be computed in the same manner as provided in subsections (d), (e), (f), (g), (h), and (i) of section 27 for the purpose of the basic surtax credit provided in section 27. For the purposes of this paragraph the net income shall be computed without regard to section 47 (c).

(3) In the case of taxable years beginning after December 31, 1950, and before April 1, 1951, and ending after March 31, 1951, there shall be levied, collected, and paid for each taxable year upon its Supplement Q net income a tax equal to 23¾ per centum of the amount thereof. In the case of taxable years beginning after March 31, 1951, and before April 1, 1954, there shall be levied, collected, and paid for each taxable year upon its Supplement Q net income a tax equal to 30 per centum of the amount thereof. In the case of taxable years beginning after March 31, 1954, there shall be levied, collected, and paid for each taxable year upon its Supplement Q net income a tax equal to 25 per centum of the amount thereof.

(4) In the case of taxable years beginning after December 31, 1950, there shall be levied, collected, and paid for each taxable year upon its Supplement Q surtax net income a tax equal to 22 per centum of the amount thereof in excess of $25,000.

(5) There shall be levied, collected, and paid for each taxable year a tax of 25 per centum of the excess, if any, of the net long-term capital gain over the sum of the net short-term capital loss and the amount of capital gain dividends paid during the year.

(6) A capital gain dividend shall be treated by the shareholders as gains from the sale or exchange of capital assets held for more than 6 months.

(7) A capital gain dividend means any dividend or part thereof which is designated by the company as a capital gain dividend in a written notice mailed to its shareholders at any time prior to the expiration of thirty days after close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated.

(8) For the purposes of this subsection, any dividend or portion thereof declared by a company after the close of the taxable year and prior to the time prescribed by law for the filing of its return for the taxable year (including the period of any extension of time granted for filing such return) shall, to the extent the company so elects in such return, be treated as having been paid during such taxable year, but only if distribution of such dividend is actually made to shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration.

[Sec. 362 as amended by secs. 209 and 211 (h), Rev. Act 1939; sec. 3 (d), Rev. Act 1940; sec. 101 (c), Second Rev. Act 1940; secs. 103 (e) and 104 (b), Rev. Act 1941; sec. 170 (a), Rev. Act 1942; sec. 121 (c), Rev. Act 1945; secs. 121 (e) and 222, Rev. Act 1950; sec. 201 (c), Excess Profits Tax Act 1950; sec. 121 (d), Rev. Act 1951]

§ 39.362-1 *Earnings and profits of a regulated investment company.* In the determination of the earnings and profits of a regulated investment company, such earnings and profits shall not be reduced by any amount which is not allowable as a deduction in computing its net income for such taxable year. See section 362 (a). Thus, if a corporation would have had earnings and profits of $500,000 for the taxable year except for the fact that it had a net capital loss of $100,000, which amount was not deductible in determining its net income, its earnings and profits for that year if it is a regulated investment company would be

$500,000. However, in determining its accumulated earnings and profits as of the beginning of the following taxable year, the earnings and profits for the previous year to be considered in such computation would amount to $400,000 assuming that there had been no distribution from such earnings and profits. For the purpose of the earnings-and-profits concept, it is immaterial whether during the taxable year a regulated investment company is taxable under Supplement Q.

§ 39.362-2 *Method of taxation of regulated investment companies.* (a) If a regulated investment company distributes during the taxable year to its shareholders as taxable dividends, other than capital gain dividends, an amount not less than 90 percent of its net income for the taxable year computed without regard to net long-term and net short-term capital gains and complies for such year with the provisions of § 39.362-3 (relating to records required to be kept for the purpose of ascertaining the actual ownership of its outstanding stock) it is taxable—

(1) Upon its Supplement Q net income (as defined in section 362 (b) (1))—

(i) For taxable years beginning before April 1, 1954, at the rate of 30 percent of the amount thereof;

(ii) For taxable years beginning after March 31, 1954, at the rate of 25 percent of the amount thereof.

(2) Upon its Supplement Q surtax net income (as defined in section 362 (b) (2)) at the rate of 22 percent of the amount thereof in excess of $25,000.

(3) Upon the excess of any net long-term capital gain over the sum of the net short-term capital loss and the amount of capital gain dividends (as defined in section 362 (b) (7)) paid during the year, at the rate of 25 percent of such excess.

(b) If a regulated investment company does not in a particular year distribute to its shareholders as taxable dividends, other than capital gain dividends, at least 90 percent of its net income computed without regard to net long-term and net short-term capital gains, it will, in spite of being classified as a regulated investment company, be taxed in that year as an ordinary corporation (that is, it will be entitled to the dividends received credit, but will not be entitled to the basic surtax credit)

(c) The term "taxable dividends" means dividends (as defined in section 115 after the application of section 362 (a)) which are taxable in the hands of such shareholders as are subject to taxation under chapter 1.

(d) A taxable dividend is not distributed to its shareholders during the taxable year within the meaning of section 362 (b) unless the dividend is received by the shareholders during the taxable year of the company. See § 39.27 (b)-2, relating to when dividends are considered paid. For certain distributions made after the close of the taxable year which the regulated investment company may elect to treat as paid during the taxable year for purposes of section 362 (b) see § 39.362-6.

(e) Due to the provision in section 362 (a) with respect to the concept of earnings and profits of a regulated investment company, even though such a company has no accumulated earnings and profits if it makes distributions during the taxable year of an amount equal to its net income for that year, regardless of the amount of losses which are not deductible against such net income, it will be allowed a basic surtax credit equal to its net income, and thus not be liable for any income tax for the taxable year provided it otherwise satisfies the requirements of Supplement Q.

(f) The terms "Supplement Q net income," "Supplement Q surtax net income," and "capital gain dividend" are defined in section 362 (b) (1), (2) and (7) respectively.

§ 39.362-3 *Records to be kept for purpose of determining whether a corporation claiming to be a regulated investment company is a personal holding company.* Every regulated investment company shall maintain in the internal revenue 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 this section to be demanded from the shareholders. The actual owner of stock 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 Internal Revenue Service, and shall be retained as long as the contents thereof may become material in the administration of any internal revenue law. For the purpose of determining whether a domestic corporation claiming to be a regulated investment company is a personal holding company as defined in section 501, the permanent records of the company shall show 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 503. Statements giving such information shall be demanded not later than 30 days after the close of the corporation's taxable year as follows:

(a) In the case of a corporation having 2,000 or more record owners of its stock on any dividend record date, from each record holder of 5 percent or more of its stock; or

(b) In the case of a corporation having less than 2,000 and more than 200 record owners of its stock, on any dividend record date, from each record holder of 1 percent or more of its stock; or

(c) In the case of a corporation having 200 or less record owners of its stock, on any dividend record date, from each record holder of one-half of 1 percent or more of its stock.

§ 39.362-4 *Additional information required in returns of shareholders.* (a) Any person who fails or refuses to comply with the demand of a regulated investment company for the written statements which § 39.362-3 requires the company to demand from its shareholders shall submit as a part of his income tax return 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 regulated 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 503 (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 regulated 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 regulated 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 regulated 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 503 and §§ 39.503 (a)-1 to 39.503 (a)-7, inclusive, and § 39.503 (b)-1; and

(7) The amount and date of receipt of each dividend received during such period from every corporation claiming to be a regulated investment company.

(b) When making demand for the written statements required of each shareholder by § 39.362-3, 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 section 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 record required by § 39.362-3. A company which fails to keep such records to show the actual ownership of its outstanding stock as are required by § 39.362-3, 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 regulated investment company.

(c) Nothing in this section or § 39.362–3 shall be construed to relieve regulated investment companies or their shareholders from the duty of filing information returns required by regulations prescribed under sections 147 and 148.

§ 39.362–5 *Method of taxation of shareholders of regulated investment companies.* Shareholders who receive capital gain dividends from a regulated investment company distributed during a taxable year of the regulated investment company for which it is taxable under section 362 (b) shall treat such dividends as gains from the sale or exchange of capital assets held for more than six months. A capital gain dividend is defined in section 362 (b) (7) as any dividend or part thereof which is designated by a regulated investment company as a capital gain dividend in a written notice mailed to its shareholders at any time prior to the expiration of 30 days after the close of its taxable year. If the aggregate amount so designated with respect to the taxable year is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated. Thus, if a regulated investment company making its return on the calendar year basis advised its shareholders by written notice mailed December 30, 1952, that of a distribution of $500,000 made December 15, 1952, $200,000 constituted a capital gain dividend, amounting to $2 per share, and it was later discovered that an error had been made in determining the excess of the net long-term capital gain over the net short-term capital loss of the taxable year and that instead of such excess being $200,000 it was $100,000, then instead of each shareholder having received a capital gain dividend of $2 per share he would have received a capital gain dividend of $1 per share. For additional rules applicable to certain distributions made after the close of the taxable year which may be designated as capital gain dividends, see § 39.362–6.

§ 39.362–6 *Distribution of dividends after close of taxable year* (a) Section 362 (b) (8) provides that:

(1) In determining under section 362 (b) whether a regulated investment company distributes during the taxable year to its shareholders as taxable dividends (other than capital gain dividends) an amount not less than 90 percent of its net income for the taxable year computed without regard to net long-term and net short-term capital gains,

(2) In computing the Supplement Q net income and the Supplement Q surtax net income, and

(3) In determining the amount of capital gain dividends paid during the taxable year,

any dividend (or portion thereof) declared by the company after the close of such taxable year and before the time prescribed by law for the filing of its return for such taxable year (including the period of any extension of time granted for filing such return) shall, to the extent the company so elects in such return, be treated as having been paid during such taxable year. This rule is applicable only if distribution of the entire amount of such dividend is actually made to shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration.

(b) The election must be made in the return filed by the company for the taxable year. The election shall be made by the taxpayer by treating the dividend (or portion thereof) to which such election applies as a dividend paid during the taxable year in computing its Supplement Q net income and its Supplement Q surtax net income, or if the dividend (or portion thereof) to which such election applies is to be designated by the company as a capital gain dividend, in computing the amount of capital gain dividends paid during such taxable year. The election provided in section 362 (b) (8) may be made only to the extent that the earnings and profits of the taxable year (computed with the application of section 362 (a)) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year (not including distributions with respect to which a prior election has been made under section 362 (b) (8)) The dividend or portion thereof, with respect to which the regulated investment company has made a valid election under section 362 (b) (8), shall be considered as paid out of earnings and profits of the taxable year for which such election is made, and not out of earnings and profits of the taxable year in which the distribution is actually made. However, the dividend or portion thereof subject to the election will be includible in the gross income of shareholders of the regulated investment company for the taxable year in which the dividend is received by them.

(c) The application of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). X Company, a regulated investment company, had a net income (and earnings or profits) for the calendar year 1952 of $100,000. During that year the company distributed to shareholders taxable dividends aggregating $88,000. On March 10, 1953, the company declared a dividend of $37,000 payable to shareholders on March 20, 1953. Such dividend consists of the first regular quarterly dividend for 1953 of $25,000 plus an additional $12,000 representing that part of the net income for 1952 which was not distributed in 1952. On March 15, 1953, X Company files its Federal income tax return and elects therein to treat $12,000 of the total dividend of $37,000 to be paid to shareholders on March 20, 1953, as having been paid during the taxable year 1952. Assuming that X Company actually distributes the entire amount of the dividend of $37,000 on March 20, 1953, an amount equal to $12,000 thereof will be treated for the purposes of section 362 (b) as having been paid during the taxable year 1952. Such amount ($12,000) will be considered a distribution out of the earnings and profits of the company for the taxable year 1952, and will be treated as a taxable dividend to the shareholders for the taxable year in which such distribution is received by them.

Example (2). Y Company, a regulated investment company, had a net income (and earnings or profits) for the calendar year 1952 of $100,000, and for 1953 a net income (and earnings or profits) of $125,000. On January 1, 1952, the company had a deficit in its earnings and profits accumulated since February 28, 1913, of $115,000. During the year 1952 the company distributed to shareholders taxable dividends aggregating $85,000. On March 5, 1953, the company declared a dividend of $65,000 payable to shareholders on March 31, 1953. On March 15, 1953, Y Company files its Federal income tax return in which it includes $40,000 of the total dividend of $65,000 to be paid to shareholders on March 31, 1953, as a dividend paid by it during the taxable year 1952. On March 31, 1953, Y Company distributes the entire amount of the dividend of $65,000 declared on March 5, 1953. The election under section 362 (b) (8) is valid only to the extent of $15,000, the amount of undistributed earnings and profits for 1952. The remainder ($50,000) of the dividend paid on March 31, 1953, may not be the subject of an election, but such amount will be regarded as a distribution by Y Company for the taxable year 1953. Assuming that the only other distribution by the Y Company during 1953 is a distribution of $75,000 paid as a dividend on October 31, 1953, the total amount of the distribution of $65,000 paid to shareholders on March 31, 1953, is to be treated as taxable dividends to the shareholders. Of this amount, $15,000 is to be treated as distributed out of the earnings or profits of the company for the taxable year 1952, and the remaining $50,000 as a distribution out of the earnings or profits for the year 1953. The distribution of $75,000 on October 31, 1953, is, of course, a taxable dividend out of the earnings and profits for the year 1953.

(d) A dividend (or portion thereof) with respect to which an election has been made under section 362 (b) (8) and which the company desires to designate as a capital gain dividend need not be so designated within 30 days after the close of the taxable year, but will be properly designated as a capital gain dividend if it is designated as such in a written notice mailed to the shareholders at the time of the payment of the dividend. Such designated capital gain dividends are to be aggregated with the designated capital gain dividends actually paid during such taxable year (not including such dividends with respect to which a prior election has been made under section 362 (b) (8)) for the purpose of determining whether the aggregate of the designated capital gain dividends with respect to such taxable year of the company is greater than the excess of the net long-term capital gain over the net short-term capital loss of the company.

(e) After the expiration of the time for filing the return for the taxable year for which an election is made under section 362 (b) (8), such election shall be irrevocable with respect to the dividend or portion thereof to which it applies.

SUPPLEMENT R—EXCHANGES AND DISTRIBUTIONS IN OBEDIENCE TO ORDERS OF SECURITIES AND EXCHANGE COMMISSION

§ 39.371 *Statutory provisions; exchanges and distributions in obedience to orders of the Securities and Exchange Commission, nonrecognition of gain or loss.*

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 and sales of property by corporations.* No gain 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 in exchange for 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. If any such property so received is nonexempt property, gain shall be recognized unless such nonexempt property or an amount equal to the fair market value of such property at the time of the transfer is, within 24 months of the transfer, under regulations prescribed by the Commissioner with the approval of the Secretary, and in accordance with an order of the Securities and Exchange Commission, expended for property other than nonexempt property or is invested as a contribution to the capital, or as paid-in surplus, of another corporation, and such order recites that such expenditure or investment 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. If the fair market value of such nonexempt property at the time of the transfer exceeds the amount expended and the amount invested, as required in the second sentence of this paragraph, the gain, if any, to the extent of such excess, shall be recognized. Any gain, to the extent that it cannot be applied in reduction of basis under section 372 (a) (2) shall be recognized. For the purposes of this subsection, a distribution in cancellation or redemption (except a distribution having the effect of a dividend) of the whole or a part of the transferor's own stock (not acquired on the transfer) and a payment in complete or partial retirement or cancellation of securities representing indebtedness of the transferor or a complete or partial retirement or cancellation of such securities which is a part of the consideration for the transfer, shall be considered an expenditure for property other than nonexempt property, and if, on the transfer, a liability of the transferor is assumed, or property of the transferor is transferred subject to a liability, the amount of such liability shall be considered to be an expenditure by the transferor for property other than nonexempt property. This subsection shall not apply unless the transferor corporation consents, at such time and in such manner as the Commissioner, with the approval of the Secretary, may by regulations prescribe, to the regulations prescribed under section 372 (a) (2) in effect at the time of filing its return for the taxable year in which the transfer occurs.

(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 groups.* (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 corporation 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) 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, expenditure, investment, distribution, or sale unless (1) the order of the Securities and Exchange Commission in obedience to which such exchange, expenditure, investment, distribution, or sale was made recites that such exchange, expenditure, investment, distribution, or sale is necessary or appropriate to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935, 49 Stat. 820 (U. S. C., title 15, sec. 79k (b)), (2) such order specifies and itemizes the stock and securities and other property which are ordered to be acquired, transferred, received, or sold upon such exchange, acquisition, expenditure, distribution, or sale, and, in the case of an investment, the investment to be made, and (3) such exchange, acquisition, expenditure, investment, distribution or sale was made in obedience to such order, and was completed within the time prescribed therefor.

(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.

[Sec. 371 as amended by sec. 171 (a) (b) (g), Rev. Act 1942]

§ 39.371-1 *Terms used.* The following terms, when used in this section and §§ 39.371-2 to 39.373-1, inclusive, shall have the meanings assigned to them in section 373: "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 section and §§ 39.371-2 to 39.373-1, inclusive, which is defined in the Internal Revenue Code, shall be given the respective definition contained in the Code.

§ 39.371-2 *Purpose and scope of exception.* (a) 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 (15 U. S. C. 79k (b)) 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 (sections 371 to 373, inclusive) 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)

(b) 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 shareholder 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) are prescribed in section 371 (e)

(c) These 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 (sections 371 to 373, inclusive) 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.

(d) The application of the provisions of Supplement R (sections 371 to 373, inclusive) 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, in the case of an exchange or sale subject to the provisions of section 371 (b) in the reduction of basis of certain property. The provisions of section 372 with respect to the continuation of basis and the reduction in basis are designed to effect these results. 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.

§ 39.371-3 *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).

§ 39.371-4 *Exchanges of property for property by corporations*—(a) *Application of section 371 (b).* Section 371 (b) applies only to the transfers specified therein with respect to which section 371 (d) is inapplicable, and deals only with such transfers if gain is realized upon the sale or other disposition effected by such transfers. If loss is realized the subsection is inapplicable and the application of other provisions of the Internal Revenue Code must be determined. See section 371 (g). If section 371 (b) is applicable, the provisions of section 112 (other than the provisions of subsection (b) (8) thereof) are inapplicable, and the conditions under, and the extent to which, the realized gain is not recognized are set forth in paragraphs (b), (c), (d) (e) and (f) of this section.

(b) *Nonrecognition of gain; no nonexempt proceeds.* No gain is recognized to a transferor corporation upon the sale or other disposition of property transferred by such transferor corporation in exchange solely for property other than nonexempt property, as defined in section 373 (e), but only if all of the following requirements are satisfied:

(1) The transferor corporation is, under the definition in section 373 (b) a registered holding company or an associate company of a registered holding company·

(2) Such transfer is in obedience to an order of the Securities and Exchange Commission (as defined in section 373 (a)) and such order satisfies the requirements of section 371 (f)

(3) The transferor corporation has filed the required consent to the regulations under section 372 (a) (2) (see paragraph (g) of this section) and

(4) The entire amount of the gain, as determined under section 111, can be applied in reduction of basis under section 372 (a) (2)

(c) *Nonrecognition of gain; nonexempt proceeds.* If the transaction would be within the provisions of paragraph (b) of this section if it were not for the fact that the property received in exchange consists in whole or in part of nonexempt property (as defined in section 373 (e)) then no gain is recognized if such nonexempt property, or an amount equal to the fair market value of such nonexempt property at the time of the transfer,

(1) Is expended within the required 24-month period for property other than nonexempt property· or

(2) Is invested within the required 24-month period as a contribution to the capital, or as paid-in surplus, of another corporation;

but only if the expenditure or investment is made

(3) In accordance with an order of the Securities and Exchange Commission (as defined in section 373 (a)) which satisfies the requirements of section 371 (f) and which recites that such expenditure or investment 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; and

(4) The required consent, waiver, and bond have been executed and filed. See paragraphs (g) and (h) of this section.

(d) *Recognition of gain in part; insufficient expenditure or investment in case of nonexempt proceeds.* If the transaction would be within the provisions of paragraph (c) of this section if it were not for the fact that the amount expended or invested is less than the fair market value of the nonexempt property received in exchange, then the gain, if any, is recognized, but in an amount not in excess of the amount by which the fair market value of such nonexempt property at the time of the transfer exceeds the amount so expended and invested.

(e) *Items treated as expenditures for the purpose of paragraphs (c) and (d) of this section.* For the purposes of paragraphs (c) and (d) of this section, the following are treated as expenditures for property other than nonexempt property:

(1) A distribution in cancellation or redemption (except a distribution having the effect of a dividend) of the whole or a part of the transferor's own stock (not acquired on the transfer)

(2) A payment in complete or partial retirement or cancellation of securities representing indebtedness of the transferor or a complete or partial retirement or cancellation of such securities which is a part of the consideration for the transfer; and

(3) If, on the transfer, a liability of the transferor is assumed, or property of the transferor is transferred subject to a liability, the amount of such liability.

(f) *Recognition of gain in part; inability to reduce basis.* If the transaction would be within the provisions of paragraph (b) or (c) of this section if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 372 (a) (2) then the gain, if any, is recognized, but in an amount not in excess of the amount which cannot be so applied in reduction of basis. If the transaction would be within the provisions of paragraph (d) of this section, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 372 (a) (2) then the gain, if any, is recognized but in an amount not in excess of the aggregate of—

(1) The amount of gain which would be recognized under paragraph (d) of this section if there were no inability to reduce basis under section 372 (a) (2) and

(2) The amount of gain which cannot be applied in reduction of basis under section 372 (a) (2)

(g) *Consent to regulations under section 372 (a) (2)* To be entitled to the benefits of the provisions of section 371 (b) a corporation must file with its return for the taxable year in which the transfer occurred a consent to have the basis of its property adjusted under section 372 (a) (2) (see § 39.372-3) in accordance with the provisions of the regulations in effect at the time of filing of the return for the taxable year in which the transfer occurs. Such consent shall be made in duplicate on Form 982A in accordance with these regulations and instructions on the form or issued therewith.

(h) *Requirements with respect to expenditure or investment.* If the full amount of the expenditure or investment required for the application of paragraph (c) of this section has not been made by the close of the taxable year in which such transfer occurred, the taxpayer shall file with the return for such year an application for the benefit of the 24-month period for expenditure and investment, reciting the nature and time of the proposed expenditure or investment. When requested by the Commissioner, the taxpayer shall execute and file (at such time and in such form) such waiver of the statute of limitations with respect to the assessment of deficiencies (for the taxable year of the transfer and for all succeeding taxable years in any of which falls any part of the period beginning with the date of the transfer and ending 24 months thereafter) as the Commissioner may specify, and such bond with such surety as the Commissioner may require in an amount not in excess of double the estimated maximum income and excess profits taxes which would be payable if the corporation does not make the required expenditure or investment within the required 24-month period.

§ 39.371-5 *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)

§ 39.371-6 *Transfers within system group.* (a) 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)

(b) 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.

(c) As stated in § 39.371-2, nonrecognition of gain or loss will not be accorded to a transaction not clearly provided for in Supplement R (sections 371 to 373, inclusive) 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)

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

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 § 39.372-6) 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.

(e) 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 provisions 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.

§ 39.371-7 *Sale of stock or securities received upon exchange by members of system group.* (a) 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.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

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, 1952, 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, 1952, 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 applied $95,000 of this amount to the retirement of its own bonds, which were outstanding on June 1, 1952. 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 this 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.

§ 39.371-8 *Exchanges in which money or other nonexempt property is received.* (a) Under section 371 (e) (1), if in any exchange (not within any of the provisions of section 371 (d)) in which 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) 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.

(b) If money or other nonexempt property is received from a corporation in an exchange described in paragraph (a) of this section 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.

§ 39.371-9 *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, expenditure, investment, distribution, or sale unless each of the following requirements is met:

(a) The order of the Securities and Exchange Commission must recite that the exchange, expenditure, investment, distribution, or sale is necessary or appropriate to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79k (b))

(b) The order shall specify and itemize the stocks and securities and other property (including money) which are ordered to be acquired, transferred, received, or sold upon such exchange, acquisition, expenditure, distribution, or sale, and, in the case of an investment, the investment to be made, so as clearly to identify such property.

(c) The exchange, acquisition, expenditure, investment, distribution, or sale shall be made in obedience to such 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.

§ 39.371-10 *Nonapplication of other provisions of the Internal Revenue Code.* 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 (sections 371 to 373, inclusive) the purpose being to prevent overlapping of the provisions of such supplement and other provisions of the Internal Revenue Code. 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 Code 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 Code as if Supplement R had not been enacted.

§ 39.371-11 *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 dispositions 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.

(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.

(10) The term "exchange" shall, wherever occurring in this paragraph, be read as "exchange, expenditure, or investment."

(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.

(3) 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 acquisition 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.

§ 39.372 *Statutory provisions; basis of property acquired in exchanges and distributions made in obedience to orders of the Securities and Exchange Commission.*

SEC. 372. *Basis for determining gain or loss*—(a) *Exchanges generally*—(1) *Exchanges subject to the provisions of section 371 (a).* If the property was acquired upon an exchange subject to the provisions of section 371 (a) 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) 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.

(2) *Exchanges subject to the provisions of section 371 (b)*. The gain not recognized upon a transfer by reason of section 371 (b) shall be applied to reduce the basis for determining gain or loss on sale or exchange of the following categories of property in the hands of the transferor immediately after the transfer, and property acquired within 24 months after such transfer by an expenditure or investment to which section 371 (b) relates on account of the acquisition of which gain is not recognized under such subsection, in the following order:

(1) Property of a character subject to the allowance for depreciation under section 23 (l);

(2) Property (not described in paragraph (1)) with respect to which a deduction for amortization is allowable under section 23 (t);

(3) Property with respect to which a deduction for depletion is allowable under section 23 (m) but not allowable under section 114 (b) (2), (3), or (4);

(4) Stock and securities of corporations not members of the system group of which the transferor is a member (other than stock or securities of a corporation of which the transferor is a subsidiary);

(5) Securities (other than stock) of corporations which are members of the system group of which the transferor is a member (other than securities of the transferor or of a corporation of which the transferor is a subsidiary);

(6) Stock of corporations which are members of the system group of which the transferor is a member (other than stock of the transferor or of a corporation of which the transferor is a subsidiary);

(7) All other remaining property of the transferor (other than stock or securities of the transferor or of a corporation of which the transferor is a subsidiary).

The manner and amount of the reduction to be applied to particular property within any of the categories described in paragraphs (1) to (7), inclusive, shall be determined under regulations prescribed by the Commissioner with the approval of the Secretary.

(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.

[Sec. 372 as amended by sec. 171 (c), Rev. Act 1942]

§ 39.372-1 *Basis for determining gain or loss*. (a) Section 113 (a) (17) provides that if property is acquired in a taxable year beginning before January 1, 1942, in any manner described in section 372 prior to its amendment by the Revenue Act of 1942, the basis shall be that provided in such section, prior to its amendment by such act, with respect to such property. Section 171 (c) of the Revenue Act of 1942 amended section 372 (a) Prior to such amendment, section 372 (a) read as follows:

(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) If the property was acquired in a taxable year beginning after December 31, 1941, in any manner described in section 372 (other than subsection (a) (2)) after its amendments, the basis shall be that prescribed in such section with respect to such property.

(c) 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 and except as provided in § 39.372-3, 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 § 39.371-2.

§ 39.372-2 *Basis of property acquired upon exchanges under section 371 (a) 371 (b) (prior to amendment by Revenue Act of 1942) or 371 (e)*. (a) 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) prior to its amendment by the Revenue Act of 1942 and in a taxable year beginning before January 1, 1942, 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. Section 371 (b) prior to its amendment by section 171 (a) of the Revenue Act of 1942, read as follows:

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.

(b) 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) prior to its amendment by the Revenue Act of 1942 and in a taxable year beginning before January 1, 1942, 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.

(c) 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) prior to its amendment by the Revenue Act of 1942 and in a taxable year beginning before January 1, 1942, 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.

(d) 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)

§ 39.372–3 *Reduction of basis of property by reason of gain not recognized under section 371 (b)*—(a) *Introductory.* In addition to the adjustments provided in section 113 (b) and the regulations relating thereto, which are required to be made with respect to the cost or other basis of property section 372 (a) (2) provides that a further adjustment shall be made in any case in which there shall have been a nonrecognition of gain under section 371 (b) realized in a taxable year beginning after December 31, 1941. Such further adjustment shall be made with respect to the basis of the property in the hands of the transferor immediately after the transfer and of the property acquired within 24 months after such transfer by an expenditure or investment to which section 371 (b) relates, and on account of which expenditure or investment gain is not recognized. If the property is in the hands of the transferor immediately after the transfer, the time of reduction is the day of the transfer; in all other cases the time of reduction is the date of acquisition. The effect of applying an amount in reduction of basis of property under section 371 (b) is to reduce by such amount the basis for determining gain upon sale or other disposition, the basis for determining loss upon sale or other disposition, the basis for depreciation and for depletion, and any other amount which the Internal Revenue Code prescribes shall be the same as any of such bases. For the purposes of the application of an amount in reduction of basis under section 371 (b) property is not considered as having a basis capable of reduction if

(1) It is money, or

(2) If its adjusted basis for determining gain at the time the reduction is to be made is zero, or becomes zero at any time in the application of section 371 (b)

(b) *General rule.* (1) Section 372 (a) (2) sets forth seven categories of property the basis of which for determining gain or loss shall be reduced in the order stated.

(2) The first category consists of all property of a character subject to the allowance for depreciation under section 23 (l) which is either in the hands of the transferor immediately after the transfer, or is acquired within 24 months after such transfer by an expenditure or investment resulting in the nonrecognition in whole or in part of gain, under section 371 (b) If any of the property in such category has a basis capable of reduction, the reduction must first be made before applying an amount in reduction of the basis of any property in the second or in a succeeding category, to each of which in turn a similar rule is applied.

(3) In the application of the rule to each category the amount of the gain not recognized shall be applied to reduce the cost or other basis of all the property in the category as follows: The cost or other basis (at the time immediately after the transfer or, if the property is not then held but is thereafter acquired, at the time of such acquisition) of each unit of property in the first category shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis at such time for determining gain, determined without regard to this section) in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) at such time of each unit of property of the taxpayer in that category bears to the aggregate of the adjusted basis (for determining gain, computed without regard to this section) at such time of all the property of the taxpayer in that category. When such adjusted basis of the property in the first category has been thus reduced to zero, a similar rule shall be applied, with respect to the portion of such gain which is unabsorbed in such reduction of the basis of the property in such category in reducing the basis of the property in the second category. A similar rule with respect to the remaining unabsorbed gain shall be applied in reducing the basis of the property in the next succeeding category.

(c) *Special cases.* (1) With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property within a particular category specified in section 372 (a) (2) adjusted in a manner different from the general rule set forth in paragraph (b) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of the taxpayer's property within a given category. A request for variations from the general rule should be filed by the taxpayer with its return for the taxable year in which the transfer of property has occurred.

(2) Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 3760. If no such agreement is entered into by the taxpayer and the Commissioner, then the consent filed on Form 982A shall (except as otherwise provided in this subparagraph) be deemed to be a consent to the application of such general rule, and such general rule shall apply in the determination of the basis of the taxpayer's property. If, however, the taxpayer specifically states on such form that it does not consent to the application of the general rule, then, in the absence of a closing agreement, the document filed shall not be deemed a consent within the meaning of the last sentence of section 371 (b)

§ 39.372–4 *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.

§ 39.372–5 *Basis of stock or securities acquired by shareholder upon tax-free distribution under section 371 (c)* (a) 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.

(b) 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 this subparagraph 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.

(c) 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)

§ 39.372–6 *Basis of property acquired under section 371 (d) in transactions between corporations of the same system group.* (a) 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 section, 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 § 39.371–6.

(b) An exception to the general rule set forth in paragraph (a) of this section 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.

(c) The application of this section may be illustrated by the following examples:

Example (1). 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.

Example (2). Suppose that in example (1) 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 example 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.

§ 39.373 *Statutory provisions; exchanges and distributions in obedience to orders of Securities and Exchange Commission, definitions.*

SEC. 373. *Definitions.* As used in this supplement—

(a) The term "order of the Securities and Exchange Commission" means an order issued after May 28, 1938, by the Securities and Exchange Commission which requires, authorizes, permits, or approves transactions described in such order to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935, 49 Stat. 820 (U. S. C., Title 15, sec. 79k (b)), which has become or becomes 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, 49 Stat. 804 (U. S. C., Supp. III, Title 15, sec. 79 (b), (c)).

(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 (A) stock which is preferred as to both dividends and assets, and (B) stock which is limited and preferred as to dividends but which is not preferred as to assets but only if the total value of such stock is less than 1 per centum of the aggregate value of all classes of stock which are not 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 evidences of indebtedness owed by the transferor or a cancellation or assumption of debts or other liabilities of the transferor (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 from a registered holding company or an associate company of a registered holding company which acquired such stock or securities after February 28, 1938, unless such stock or securities (other than obligations described as nonexempt property in paragraph (1), (2), or (3)) were acquired in obedience to an order of the Securities and Exchange Commission or were acquired with the authorization or approval of the Securities and Exchange Commission under any section of the Public Utility Holding Company Act of 1935, 49 Stat. 820 (U. S. C., Title 15, sec. 79k (b));

(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).

[Sec. 373 as amended by sec. 221 (a), Rev. Act 1939; sec. 117 (a), Rev. Act 1941; sec. 171 (d), (e), and (f), Rev. Act. 1942; sec. 338, Rev. Act 1951]

§ 39.373-1 *Definitions*—(a) *Order of the Securities and Exchange Commission.* (1) 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 (15 U. S. C. 79k (b) (e)) to effectuate the provisions of section 11 (b) of such Act. In all cases the order must become or 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)

(2) 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.

(3) 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.* (1) Under section 5 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79e) 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. As used in this part, the term "registered holding company" 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 (15 U. S. C. 79b (a) (7)), 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 (15 U. S. C. c. 2 C) An electric utility company is defined by section 2 (a) (3) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b (a) (3)) 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 (15 U. S. C. 79b (a) (4)) 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.

(2) 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 (15 U. S. C. 79b (a) (9)) 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 (15 U. S. C. 79b (a) (8)) which in general include all companies 10 percent of whose outstanding voting securities is owned di-

rectly 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 (15 U. S. C. 79m) The term "member company" is defined by section 2 (a) (14) of such act (15 U. S. C. 79b (a) (14)) to mean a company which is a member of an association or group of companies mutually served by a mutual service company.

(3) The term "associate company" has the meaning assigned to it by section 2 (a) (10) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b (a) (10)) 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 (1) stock which is preferred as to both dividends and assets, and (2) stock which is limited and preferred as to dividends but which is not preferred as to assets but only if the total value of such stock is less than 1 percent of the aggregate value of all classes of stock which are not 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 if the common parent corporation owns directly at least 90 percent of each class of stock (other than stock preferred as to both dividends and assets) of at least one of the other corporations; but no corporation is a member of a system group unless it is either a registered holding company or a majority-owned subsidiary company. While the type of stock which must, for the purpose of this definition, be at least 90 percent owned 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) 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 and including the amount of any consideration in the form of evidences of indebtedness owned by the transferor) 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,

(i) The Y Corporation cancels $100,000 of indebtedness owed to it by the X Corporation;

(ii) The Y Corporation assumes an indebtedness of $100,000 owed by the X Corporation to another company, the A Corporation; or

(iii) 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 from a registered holding company which acquired such stock or securities after February 28, 1938, or an associate company of a registered holding company which acquired such stock or securities 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)) or were acquired with the authorization or approval of the Securities and Exchange Commission under any section of the Public Utility Holding Company Act of 1935, and are not non-exempt property within the meaning of section 373 (e) (1) (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.

SUPPLEMENT S—TAX OF SHAREHOLDERS OF PERSONAL SERVICE CORPORATIONS

§ 39.391 *Statutory provisions; personal service corporations; applicability of Supplement S.*

SEC. 391. *Applicability of supplement.* If a personal service corporation (as defined in section 449) is exempt under such section for any taxable year from the excess profits tax imposed by such subchapter, the provisions of this Supplement shall be applicable with respect to each shareholder of such corporation who was a shareholder in such corporation on the last day of such taxable year of the corporation.

[Sec. 391 as added by sec. 502, Second Rev. Act 1940; amended by sec. 304 (f), Excess Profits Tax Act 1950]

§ 39.391-1 *Applicability of Supplement S.* If a personal service corporation elects not to be subject to the excess profits tax for any taxable year, then Supplement S shall be applicable with respect to each person who was a shareholder of such corporation at the close of the taxable year of the corporation. For definition of a personal service corporation and for method of election, see section 449 and the regulations thereunder.

§ 39.392 *Statutory provisions; personal service corporations; undistributed Supplement S net income.*

SEC. 392. *Undistributed Supplement S net income.* For the purposes of this chapter, the term "undistributed Supplement S net income" means the Supplement S net income (as defined in section 393) minus the amount of the dividends paid during the taxable year. For the purposes of this section the amount of dividends paid shall be computed in the same manner as provided in subsections (d), (e), (f), (g), (h), and (i) of section 27 for the purpose of the basic surtax credit provided in section 27.

[Sec. 392 as added by sec. 502, Second Rev. Act 1940]

§ 39.392-1 *Undistributed Supplement S net income.* The term "undistributed Supplement S net income" means Supplement S net income (as defined in section 393) minus the amount of dividends paid by the corporation during the taxable year. For the method of computing dividends paid, see subsections (d) (e) (f) (g) (h) and (i) of section 27 and the regulations thereunder.

§ 39.393 *Statutory provisions; personal service corporations; supplement S net income.*

SEC. 393. *Supplement S net income.* For the purposes of this chapter "Supplement S net income" means the net income, except that there shall be allowed as additional deductions—

(a) The Federal income tax payable under this chapter for the taxable year; and

(b) 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 corporation's net income, computed without the benefit of this subsection and section 23 (q). For the purposes of this section, the net income shall be computed without regard to section 47 (c).

[Sec. 393 as added by sec. 502, Second Rev. Act 1940; amended by sec. 135 (b) (3), Rev. Act 1942]

§ 39.393–1 *Supplement S net income.* (a) The term "Supplement S net income" means the net income as defined in section 21, but computed without the deduction allowed under section 23 (q) minus the sum of the following:

(1) The Federal income tax payable under chapter 1 for the taxable year; and

(2) The amount of contributions or gifts made 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 percent of the net income of the corporation computed without the benefit of sections 23 (q) and 393 (b)

In the case of a taxable year of less than 12 months on account of a change in the accounting period of the corporation, the corporate net income, as defined in section 21, is computed on the basis of the period included in the taxable year, and is not placed on an annual basis under the provisions of section 47 (c)

(b) The deductions allowed under section 393 for contributions or gifts made to or for the use of donees described in section 23 (q) are in lieu of deductions otherwise allowable under section 23 (q) and are allowable 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.

(c) The provisions of paragraphs (g) and (h) of § 39.23 (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 amounts of contributions or gifts by corporations under section 393.

(d) The method of computing Supplement S net income may be illustrated by the following example:

Example. The X Corporation, a personal service corporation, has for the calendar year 1952 a net income, as computed under chapter 1, of $190,000. The Federal income tax payable under chapter 1 for that year amounts to $93,300. Contributions or gifts payment of which is made during the taxable year to or for the use of donees described in section 23 (q) for the purposes therein specified amount to $35,000. The Supplement S net income of the corporation is $76,700, computed as follows:

Net income under chapter 1		$190,000
Add: Contributions deductible in computing net income under section 21		10,000
Net income computed without the benefit of any deduction for contributions		200,000
Less: Federal income tax on $190,000	$93,300	
Contributions deductible under section 393 (b) (15 percent of $200,000)	30,000	
		123,300
Supplement S net income		76,700

§ 39.394 *Statutory provisions; personal service corporations; income taxed to shareholders.*

SEC. 394. *Corporation income taxed to shareholders*—(a) *General rule.* The undistributed Supplement S net income of a personal service corporation shall be included in the gross income of the shareholders in the manner and to the extent set forth in this Supplement.

(b) *Amount included in gross income.* Each shareholder who, on the last day of the taxable year of the corporation, was a shareholder in such corporation shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend if on such last day there had been distributed by the corporation, and received by the shareholders, an amount equal to the undistributed Supplement S net income of the corporation for its taxable year.

(c) *Credit for obligations of the United States and its instrumentalities.* Each such shareholder shall be allowed a credit against net income, for the purposes of the tax imposed by section 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 corporation. For any taxable year of the corporation beginning after December 31, 1941, each such shareholder's proportionate share of such interest received by the corporation shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 23 (v) as is attributable to such share.

(d) *Effect on capital account of personal service corporation.* An amount equal to the undistributed Supplement S net income of the personal service corporation for its taxable year shall be considered as paid in as of the close of such taxable year as paid-in surplus or as a contribution to capital, and the accumulated earnings and profits as of the close of such taxable year shall be correspondingly reduced, if such amount or any portion thereof is required to be included as a dividend in the gross income of the shareholders.

(e) *Basis of stock in hands of shareholders.* The amount required to be included in the gross income of the 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.

(f) *Period of limitation on assessment and collection.* For period of limitation on assessment and collection without assessment, in the case of failure to include in gross income the amount properly includible therein under subsection (b), see section 275 (d).

[Sec. 394 as added by sec. 502, Second Rev. Act 1940; amended by sec. 126 (h) Rev. Act 1942]

§ 39.394–1 *Taxability of shareholders.* If a personal service corporation is exempt from the excess profits tax imposed under subchapter D of chapter 1 for any taxable year by reason of an election under section 449, the undistributed Supplement S net income of the corporation shall be treated as a dividend received by those who, at the close of the taxable year of the corporation, were the shareholders of the corporation and as such would have been entitled to receive such income as a dividend had it been distributed at that time. Each such shareholder for his taxable year in which or with which the taxable year of the corporation ends, shall include in his gross income his proportionate share of such undistributed Supplement S net income as though such proportionate share had been received as a dividend on the last day of the taxable year of the corporation. Such amount is to be determined by reference to the interest of the shareholder in the corporation, that is, by reference to the number of shares of stock owned and the relative rights of each class of stock if there are several classes of stock outstanding. Thus, if a personal service corporation 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 holders of the common stock, then the assumed distribution of the undistributed Supplement S 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.

§ 39.394–2 *Credit for interest on obligations of the United States and its instrumentalities.* Each shareholder of a personal service corporation who as of the last day of the taxable year of the corporation is required to include in his gross income his proportionate share of the undistributed Supplement S net income of the corporation shall, for the purposes of the tax imposed by section 11 (normal tax on individuals), section 13 (normal tax on corporations), section 201 (tax on life insurance companies), section 204 (tax on insurance companies other than life or mutual), section 207 (tax on mutual insurance companies other than life or marine) or section 362 (tax on regulated investment companies) be allowed a credit against net income of his proportionate share of the interest specified in section 25 (a) (1), interest on United States obligations, or section 25 (a) (2), interest on obligations of instrumentalities of the United States, which is included in the gross income of the corporation. For reduction of credit for such interest on account of amortizable bond premium, see § 39.125 (c)–2.

§ 39.394–3 *Effect on capital account of personal service corporation.* If the undistributed Supplement S net income of a personal service corporation, or any portion thereof, for any taxable year is required to be included in the gross income of the shareholders, such undis-

tributed Supplement S net income shall, for income and excess profits tax purposes, be treated as paid-in surplus or as a contribution to capital, paid in as of the close of such taxable year and the accumulated earnings and profits of the corporation shall be correspondingly reduced.

§ 39.394-4 *Basis of stock in hands of shareholders.* If a shareholder of a personal service corporation is required to include in his gross income his proportionate part of the undistributed Supplement S net income of the corporation, the amount so included shall, for the purpose of adjusting the basis of his stock with respect to such proportionate part, be treated as a distribution actually made by the corporation and as a reinvestment in the corporation by the shareholder. It shall, however, be so treated only to the extent to which such amount is included in the return of the shareholder, increased or decreased by any adjustment of such amount in the last determination of the tax liability of the shareholder made before the expiration of seven years after the date prescribed by law for the filing of his return.

§ 39.395-396 *Statutory provisions; personal service corporations; nonresident alien individuals and foreign corporations; payment of shareholder's tax.*

SEC. 395. *Nonresident alien individuals and foreign corporations.* In the case of a shareholder taxable under section 211 (a) or 231 (a), his distributive share of the undistributed Supplement S net income of the corporation required to be included in the gross income shall be considered as a dividend received by him from sources within the United States.

[Sec. 395 as added by sec. 502, Second Rev. Act 1940]

SEC. 396. *Shareholder's tax paid by corporation.* If a personal service corporation is exempt for any taxable year under section 449 from excess profits tax, it shall, at the time of filing its return, pay to the collector an amount equal to the amount that would be required by section 143 (b) or section 144 to be deducted and withheld by the corporation if any amount required by this Supplement to be included in the gross income of the shareholder had been, on the last day of the taxable year of the corporation, paid to the shareholder in cash as a dividend. Such amount shall be collected and paid 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 in the face of the return.

[Sec. 396, as added by sec. 502, Second Rev. Act 1940; amended by sec. 304 (f), Excess Profits Tax Act 1950]

§ 39.396-1 *Tax of certain shareholders paid by the corporation.* Since a shareholder's proportionate share of the undistributed Supplement S net income of a corporation electing not to be subject to the excess profits tax imposed under subchapter D of chapter 1 is taxable to such shareholder, the corporation is required, at the time of filing its income tax return under chapter 1, to pay to the district director an amount equal to the amount that would be required by section 143 (b) or section 144 to be deducted and withheld by the corporation had its undistributed Supplement S net income been actually paid in cash to its shareholders as a dividend on the last day of its taxable year.

SUPPLEMENT T—INDIVIDUALS WITH ADJUSTED GROSS INCOME OF LESS THAN $5,000

§ 39.400 *Statutory provisions; tax under Supplement T: imposition of tax.*

SEC. 400. *Imposition of tax.* In lieu of the taxes imposed by sections 11 and 12, there shall be levied, collected, and paid for each taxable year upon the net income of each individual whose adjusted gross income for such year is less than $5,000, and who has elected to pay the tax imposed by this supplement for such year, a tax as follows:

TABLE I—TAXABLE YEAR BEGINNING JANUARY 1, 1951, AND ENDING DECEMBER 31, 1951

* * * * *

TABLE II—TAXABLE YEARS BEGINNING AFTER OCT. 31, 1951, AND BEFORE JAN. 1, 1954

If adjusted gross income is— At least	But less than	And the number of exemptions is— 1	2	3	4 or more
		The tax shall be—			
$0	$675	$0	$0	$0	$0
675	700	4	0	0	0
700	725	9	0	0	0
725	750	14	0	0	0
750	775	19	0	0	0
775	800	24	0	0	0
800	825	29	0	0	0
825	850	34	0	0	0
850	875	39	0	0	0
875	900	44	0	0	0
900	925	49	0	0	0
925	950	54	0	0	0
950	975	59	0	0	0
975	1,000	64	0	0	0
1,000	1,025	69	0	0	0
1,025	1,050	74	0	0	0
1,050	1,075	79	0	0	0
1,075	1,100	84	0	0	0
1,100	1,125	89	0	0	0
1,125	1,150	94	0	0	0
1,150	1,175	99	0	0	0
1,175	1,200	104	0	0	0
1,200	1,225	109	0	0	0
1,225	1,250	114	0	0	0
1,250	1,275	119	0	0	0
1,275	1,300	124	0	0	0
1,300	1,325	129	0	0	0
1,325	1,350	134	1	0	0
1,350	1,375	139	6	0	0
1,375	1,400	144	11	0	0
1,400	1,425	149	16	0	0
1,425	1,450	154	21	0	0
1,450	1,475	159	26	0	0
1,475	1,500	164	31	0	0
1,500	1,525	169	36	0	0
1,525	1,550	174	41	0	0
1,550	1,575	179	46	0	0
1,575	1,600	184	51	0	0
1,600	1,625	189	56	0	0
1,625	1,650	194	61	0	0
1,650	1,675	199	66	0	0
1,675	1,700	204	71	0	0
1,700	1,725	209	76	0	0
1,725	1,750	214	81	0	0
1,750	1,775	219	86	0	0
1,775	1,800	224	91	0	0
1,800	1,825	229	96	0	0
1,825	1,850	234	101	0	0
1,850	1,875	239	106	0	0
1,875	1,900	244	111	0	0
1,900	1,925	249	116	0	0
1,925	1,950	254	121	0	0
1,950	1,975	259	126	0	0
1,975	2,000	264	131	0	0
2,000	2,025	269	136	2	0
2,025	2,050	274	141	7	0
2,050	2,075	279	146	12	0
2,075	2,100	284	151	17	0
2,100	2,125	289	156	22	0
2,125	2,150	294	161	27	0
2,150	2,175	299	166	32	0
2,175	2,200	304	171	37	0
2,200	2,225	309	176	42	0
2,225	2,250	314	181	47	0
2,250	2,275	319	186	52	0
2,275	2,300	324	191	57	0
2,300	2,325	329	196	62	0

If adjusted gross income is— At least	But less than	And the number of exemptions is— 1: And taxpayer is single or married filing separately	1: And taxpayer is head of household	2: And taxpayer is single or married filing separately	2: And taxpayer is head of household	2: And a joint return is filed	3: And taxpayer is single or married filing separately	3: And taxpayer is head of household	3: And a joint return is filed	4	5	6	7	8 or more
		The tax shall be—												
$2,325	$2,350	$334	$334	$201	$201	$201	$67	$67	$67	$0	$0	$0	$0	$0
2,350	2,375	339	339	206	206	206	72	72	72	0	0	0	0	0
2,375	2,400	344	344	211	211	211	77	77	77	0	0	0	0	0
2,400	2,425	349	349	216	216	216	82	82	82	0	0	0	0	0
2,425	2,450	354	354	221	221	221	87	87	87	0	0	0	0	0
2,450	2,475	359	359	226	226	226	92	92	92	0	0	0	0	0
2,475	2,500	364	364	231	231	231	97	97	97	0	0	0	0	0
2,500	2,525	369	369	236	236	236	102	102	102	0	0	0	0	0
2,525	2,550	374	374	241	241	241	107	107	107	0	0	0	0	0
2,550	2,575	379	379	246	246	246	112	112	112	0	0	0	0	0
2,575	2,600	384	384	251	251	251	117	117	117	0	0	0	0	0
2,600	2,625	389	389	256	256	256	122	122	122	0	0	0	0	0
2,625	2,650	394	394	261	261	261	127	127	127	0	0	0	0	0
2,650	2,675	399	399	266	266	266	132	132	132	0	0	0	0	0
2,675	2,700	404	404	271	271	271	137	137	137	4	0	0	0	0
2,700	2,725	409	409	276	276	276	142	142	142	9	0	0	0	0
2,725	2,750	414	414	281	281	281	147	147	147	14	0	0	0	0
2,750	2,775	419	419	286	286	286	152	152	152	19	0	0	0	0
2,775	2,800	424	424	291	291	291	157	157	157	24	0	0	0	0
2,800	2,825	429	429	296	296	296	162	162	162	29	0	0	0	0
2,825	2,850	434	434	301	301	301	167	167	167	34	0	0	0	0
2,850	2,875	439	439	306	306	306	172	172	172	39	0	0	0	0
2,875	2,900	444	444	311	311	311	177	177	177	44	0	0	0	0
2,900	2,925	449	449	316	316	316	182	182	182	49	0	0	0	0
2,925	2,950	455	454	321	321	321	187	187	187	54	0	0	0	0
2,950	2,975	460	459	326	326	326	192	192	192	59	0	0	0	0
2,975	3,000	466	465	331	331	331	197	197	197	64	0	0	0	0
3,000	3,050	474	473	338	335	333	205	205	205	72	0	0	0	0
3,050	3,100	485	483	348	345	343	215	215	215	82	0	0	0	0
3,100	3,150	496	494	358	355	353	225	225	225	92	0	0	0	0
3,150	3,200	507	504	368	365	363	235	235	235	102	0	0	0	0
3,200	3,250	518	515	378	375	373	245	245	245	112	0	0	0	0
3,250	3,300	529	525	388	385	383	255	255	255	122	0	0	0	0
3,300	3,350	541	536	398	395	393	265	265	265	132	0	0	0	0
3,350	3,400	552	546	408	405	403	275	275	275	142	5	0	0	0
3,400	3,450	563	557	418	415	413	285	285	285	152	13	0	0	0
3,450	3,500	574	567	428	425	423	295	295	295	162	23	0	0	0
3,500	3,550	585	578	438	435	433	305	305	305	171	33	0	0	0
3,550	3,600	596	588	448	445	443	315	315	315	181	43	0	0	0
3,600	3,650	607	599	459	455	453	325	325	325	191	53	0	0	0
3,650	3,700	618	610	470	469	463	335	335	335	201	63	0	0	0
3,700	3,750	629	620	482	480	473	345	345	345	211	73	0	0	0
3,750	3,800	640	631	493	490	483	355	355	355	221	83	0	0	0
3,800	3,850	651	641	504	501	493	365	365	365	231	93	0	0	0
3,850	3,900	662	652	515	511	503	375	375	375	241	103	0	0	0
3,900	3,950	673	662	526	522	513	385	385	385	251	113	0	0	0
3,950	4,000	684	673	537	532	523	395	395	395	261	123	0	0	0
4,000	4,050	696	683	548	543	533	405	405	405	271	133	5	0	0
4,050	4,100	707	694	559	553	543	415	415	415	281	143	15	0	0
4,100	4,150	718	704	570	564	553	425	425	425	291	153	25	0	0
4,150	4,200	729	715	581	574	563	435	435	435	301	163	35	0	0
4,200	4,250	740	725	592	585	573	445	445	445	311	173	45	0	0
4,250	4,300	751	736	603	595	583	456	455	455	321	183	55	0	0
4,300	4,350	762	746	614	606	593	467	465	465	331	193	65	0	0
4,350	4,400	773	757	625	617	603	478	476	475	341	203	75	0	0
4,400	4,450	784	768	636	627	613	489	487	485	351	213	85	0	0
4,450	4,500	795	778	647	638	623	500	497	494	361	223	95	0	0
4,500	4,550	806	789	659	648	633	511	508	504	371	233	105	0	0
4,550	4,600	817	799	670	659	643	522	518	514	381	243	115	0	0
4,600	4,650	828	810	681	669	653	533	529	524	391	253	125	0	0
4,650	4,700	839	820	692	680	663	544	539	534	401	263	135	2	0
4,700	4,750	851	831	703	690	673	555	550	544	411	273	145	12	0
4,750	4,800	862	841	714	701	683	566	560	554	421	283	155	22	0
4,800	4,850	873	852	725	711	693	577	571	564	431	293	165	32	0
4,850	4,900	884	862	736	722	703	589	581	574	441	303	175	42	0
4,900	4,950	895	873	747	732	713	600	592	584	451	313	185	52	0
4,950	5,000	906	883	758	743	723	611	603	594	461	323	195	62	0

TABLE III—TAXABLE YEARS BEGINNING AFTER DEC. 31, 1953

If adjusted gross income is— At least	But less than	And the number of exemptions is— 1	2	3	4 or more	If adjusted gross income is— At least	But less than	And the number of exemptions is— 1: And taxpayer is single or married filing separately	1: And taxpayer is head of household	2: And taxpayer is single or married filing separately	2: And taxpayer is head of household	2: And a joint return is filed	3: And taxpayer is single or married filing separately	3: And taxpayer is head of household	3: And a joint return is filed	4	5	6	7	8 or more
		The tax shall be—						The tax shall be—												
$0	$675	$0	$0	$0	$0	$2,325	$2,350	$301	$301	$181	$181	$181	$61	$61	$61	$0	$0	$0	$0	$0
675	700	4	0	0	0	2,350	2,375	305	305	185	185	185	65	65	65	0	0	0	0	0
700	725	8	0	0	0	2,375	2,400	310	310	190	190	190	70	70	70	0	0	0	0	0
725	750	13	0	0	0	2,400	2,425	314	314	194	194	194	74	74	74	0	0	0	0	0
750	775	17	0	0	0	2,425	2,450	319	319	199	199	199	79	79	79	0	0	0	0	0
775	800	22	0	0	0	2,450	2,475	323	323	203	203	203	83	83	83	0	0	0	0	0
800	825	26	0	0	0	2,475	2,500	328	328	208	208	208	88	88	88	0	0	0	0	0
825	850	31	0	0	0	2,500	2,525	332	332	212	212	212	92	92	92	0	0	0	0	0
850	875	35	0	0	0	2,525	2,550	337	337	217	217	217	97	97	97	0	0	0	0	0
875	900	40	0	0	0	2,550	2,575	341	341	221	221	221	101	101	101	0	0	0	0	0
900	925	44	0	0	0	2,575	2,600	346	346	226	226	226	106	106	106	0	0	0	0	0
925	950	49	0	0	0	2,600	2,625	350	350	230	230	230	110	110	110	0	0	0	0	0
950	975	53	0	0	0	2,625	2,650	355	355	235	235	235	115	115	115	0	0	0	0	0
975	1,000	58	0	0	0	2,650	2,675	359	359	239	239	239	119	119	119	0	0	0	0	0
1,000	1,025	62	0	0	0	2,675	2,700	364	364	244	244	244	124	124	124	4	0	0	0	0
1,025	1,050	67	0	0	0	2,700	2,725	368	368	248	248	248	128	128	128	8	0	0	0	0
1,050	1,075	71	0	0	0	2,725	2,750	373	373	253	253	253	133	133	133	13	0	0	0	0
1,075	1,100	76	0	0	0	2,750	2,775	377	377	257	257	257	137	137	137	17	0	0	0	0
1,100	1,125	80	0	0	0	2,775	2,800	382	382	262	262	262	142	142	142	22	0	0	0	0
1,125	1,150	85	0	0	0	2,800	2,825	386	386	266	266	266	146	146	146	26	0	0	0	0
1,150	1,175	89	0	0	0	2,825	2,850	391	391	271	271	271	151	151	151	31	0	0	0	0
1,175	1,200	94	0	0	0	2,850	2,875	395	395	275	275	275	155	155	155	35	0	0	0	0
1,200	1,225	98	0	0	0	2,875	2,900	400	400	280	280	280	160	160	160	40	0	0	0	0
1,225	1,250	103	0	0	0	2,900	2,925	405	404	284	284	284	164	164	164	44	0	0	0	0
1,250	1,275	107	0	0	0	2,925	2,950	410	409	289	289	289	169	169	169	49	0	0	0	0
1,275	1,300	112	0	0	0	2,950	2,975	415	414	293	293	293	173	173	173	53	0	0	0	0
1,300	1,325	116	0	0	0	2,975	3,000	420	419	298	298	298	178	178	178	58	0	0	0	0
1,325	1,350	121	1	0	0	3,000	3,050	427	426	305	305	305	185	185	185	65	0	0	0	0
1,350	1,375	125	5	0	0	3,050	3,100	437	435	314	314	314	194	194	194	74	0	0	0	0
1,375	1,400	130	10	0	0	3,100	3,150	447	445	323	323	323	203	203	203	83	0	0	0	0
1,400	1,425	134	14	0	0	3,150	3,200	457	454	332	332	332	212	212	212	92	0	0	0	0
1,425	1,450	139	19	0	0	3,200	3,250	467	464	341	341	341	221	221	221	101	0	0	0	0
1,450	1,475	143	23	0	0	3,250	3,300	476	473	350	350	350	230	230	230	110	0	0	0	0
1,475	1,500	148	28	0	0	3,300	3,350	486	482	359	359	359	239	239	239	119	0	0	0	0
1,500	1,525	152	32	0	0	3,350	3,400	496	492	368	368	368	248	248	248	128	8	0	0	0
1,525	1,550	157	37	0	0	3,400	3,450	506	501	377	377	377	257	257	257	137	17	0	0	0
1,550	1,575	161	41	0	0	3,450	3,500	516	511	386	386	386	266	266	266	146	26	0	0	0
1,575	1,600	166	46	0	0	3,500	3,550	526	520	395	395	395	275	275	275	155	35	0	0	0
1,600	1,625	170	50	0	0	3,550	3,600	536	530	404	404	404	284	284	284	164	44	0	0	0
1,625	1,650	175	55	0	0	3,600	3,650	546	539	414	413	413	293	293	293	173	53	0	0	0
1,650	1,675	179	59	0	0	3,650	3,700	556	549	424	423	422	302	302	302	182	62	0	0	0
1,675	1,700	184	64	0	0	3,700	3,750	566	558	434	432	431	311	311	311	191	71	0	0	0
1,700	1,725	188	68	0	0	3,750	3,800	575	567	443	441	440	320	320	320	200	80	0	0	0
1,725	1,750	193	73	0	0	3,800	3,850	585	577	453	451	449	329	329	329	209	89	0	0	0
1,750	1,775	197	77	0	0	3,850	3,900	595	586	463	460	458	338	338	338	218	98	0	0	0
1,775	1,800	202	82	0	0	3,900	3,950	605	596	473	470	467	347	347	347	227	107	0	0	0
1,800	1,825	206	86	0	0	3,950	4,000	615	605	483	479	476	356	356	356	236	116	0	0	0
1,825	1,850	211	91	0	0	4,000	4,050	625	615	493	489	485	365	365	365	245	125	5	0	0
1,850	1,875	215	95	0	0	4,050	4,100	635	624	503	498	494	374	374	374	254	134	14	0	0
1,875	1,900	220	100	0	0	4,100	4,150	645	634	513	508	503	383	383	383	263	143	23	0	0
1,900	1,925	224	104	0	0	4,150	4,200	655	643	523	517	512	392	392	392	272	152	32	0	0
1,925	1,950	229	109	0	0	4,200	4,250	665	653	533	527	521	401	401	401	281	161	41	0	0
1,950	1,975	233	113	0	0	4,250	4,300	674	662	542	536	530	410	410	410	290	170	50	0	0
1,975	2,000	238	118	0	0	4,300	4,350	684	671	552	545	539	420	419	419	299	179	59	0	0
2,000	2,025	242	122	2	0	4,350	4,400	694	681	562	555	548	430	429	428	308	188	68	0	0
2,025	2,050	247	127	7	0	4,400	4,450	704	690	572	564	557	440	438	437	317	197	77	0	0
2,050	2,075	251	131	11	0	4,450	4,500	714	700	582	574	566	450	448	446	326	206	86	0	0
2,075	2,100	256	136	16	0	4,500	4,550	724	709	592	583	575	460	457	455	335	215	95	0	0
2,100	2,125	260	140	20	0	4,550	4,600	734	719	602	593	584	470	467	464	344	224	104	0	0
2,125	2,150	265	145	25	0	4,600	4,650	744	728	612	602	593	480	476	473	353	233	113	0	0
2,150	2,175	269	149	29	0	4,650	4,700	754	738	622	612	602	490	486	482	362	242	122	2	0
2,175	2,200	274	154	34	0	4,700	4,750	764	747	632	621	611	500	495	491	371	251	131	11	0
2,200	2,225	278	158	38	0	4,750	4,800	773	756	641	630	620	509	504	500	380	260	140	20	0
2,225	2,250	283	163	43	0	4,800	4,850	783	766	651	640	629	519	514	509	389	269	149	29	0
2,250	2,275	287	167	47	0	4,850	4,900	793	775	661	649	638	529	523	518	398	278	158	38	0
2,275	2,300	292	172	52	0	4,900	4,950	803	785	671	659	647	539	533	527	407	287	167	47	0
2,300	2,325	296	176	56	0	4,950	5,000	813	794	681	668	656	549	542	536	416	296	176	56	0

[Sec. 400 as added by sec. 102 (a), Rev. Act 1941; amended by sec. 104 (a), Rev. Act 1942; sec. 102 (a), Rev. Act 1943; sec. 5 (a), Individual Income Tax Act 1944; sec. 103 (a), Rev. Act 1945; sec. 2, Pub. Law 390 (78th Cong.); sec. 401, Rev. Act 1948; sec. 102, Rev. Act 1950; sec. 102, Rev. Act 1951]

§ 39.400–1 *Scope and application of Supplement T* (a) (1) In lieu of the taxes imposed by sections 11 and 12, an individual may elect to pay the tax imposed by section 400 if his adjusted gross income is less than $5,000, regardless of the sources from which such income is derived and regardless of whether such income is computed on the cash basis or on the accrual basis.

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

Example. A is employed at a salary of $4,600 for the calendar year 1952. In the course of such employment, he incurred travel expenses of $750 for which he was reimbursed during the year. Such items constitute his sole income for 1952. In such case the gross income is $5,350 but the amount of $750 is deducted from gross income in the determination of adjusted gross income and thus A's adjusted gross income for 1952 is $4,600. Hence, the adjusted gross income being less than $5,000, he may elect to pay his tax for 1952 under Supplement T. Similarly, in the case of an individual engaged in trade or business (excluding from the term "engaged in trade or business" the performance of personal services as an employee), there may be deducted from gross income in ascertaining adjusted gross income those expenses directly relating to the carrying on of such trade or business.

(b) (1) For the purposes of determining whether a taxpayer may elect to pay the tax under Supplement T, the amount of the adjusted gross income is controlling, without reference to the number of exemptions to which the taxpayer may be entitled.

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

Example. If X has, as his only income for 1952, a salary of $5,800 and his spouse has no gross income and derives her entire support from X, then X's adjusted gross income is $5,800 (not $5,800 minus $1,200 or $4,600) and he is not, for such year, entitled to pay his tax under Supplement T. If, however, X has for 1952 a salary of $6,000 and incident to his employment he incurs expenses in the amount of $1,200 for travel, meals, and lodging while away from home, the adjusted gross income is $6,000 minus $1,200, or $4,800. In such case his adjusted gross income being less than $5,000, X may elect to pay the tax under Supplement T. If, however, X's wife has adjusted gross income of $200, thus bringing the aggregate adjusted gross income to $5,000 and his wife joins in a joint return, the taxpayer cannot elect to pay the tax under Supplement T.

(c) In the case of husband and wife, if their aggregate adjusted gross income is less than $5,000 and each is required to file a return both must, or neither can, elect to pay the tax under Supplement T. If, however, one of such spouses has adjusted gross income of $5,000 or more and the other spouse has adjusted gross income of less than $5,000, the latter spouse may elect to pay the tax under Supplement T provided that the other spouse elects to take the standard deduction provided in section 23 (aa) The restrictions upon the right of a married person to elect to pay the tax under Supplement T are applicable unless such person is legally separated from his spouse under a decree of divorce or separate maintenance on the last day of his taxable year or, in the event of the death of his spouse during the taxable year, upon the date of such death. For rules relative to the application of these restrictions, see paragraph (c) of § 39.23 (aa)–1.

(d) (1) To determine the amount of the tax, the individual ascertains the amount of his adjusted gross income, refers to the table set forth in section 400 which is applicable to the taxable year, ascertains the income bracket into which such income falls, and, using the number of exemptions applicable to his case, finds the tax in the vertical column having at the top thereof a number corresponding to the number of exemptions to which the taxpayer is entitled.

(2) The tax tables in section 400 contain, in certain instances, double columns, in one of which is shown the tax if the taxpayer is single (and not the head of a household) or married and files a separate return, and in the other of which is shown the tax if the taxpayer is the head of a household. In other instances, such tables contain triple columns, in the first of which is shown the tax if the taxpayer is single (and not the head of a household) or married and files a separate return, in the second of which is shown the tax if the taxpayer is the head of a household, and in the third of which is shown the tax if a joint return is filed. In the case of double or triple columns, the tax shall be determined by reference to the applicable column.

(3) Since the computations of tax shown in the tables in the case of a joint return reflect the income-splitting method provided in section 12 (d) the tax shown in the joint return column may be lower than that shown in the separate return column even though the amounts of adjusted gross income and the exemptions are the same. Thus, if H, a married man, has adjusted gross income of $4,925 for the calendar year 1952 and his wife has no gross income for such year and his only exemptions under section 25 (b) are the exemptions for himself and spouse under section 25 (b) (1) (A) the tax on a joint return under Supplement T, as shown in the second column applicable to a person with two exemptions, is $718. If H should file a separate return, his tax, as shown in the first column applicable to an individual with two exemptions, would be $747.

(e) If a joint return of a husband and wife is filed under the provisions of section 51 (b) (3) if the husband and wife have different taxable years solely because of the death of either spouse, and if the taxable year of the surviving spouse covered by such joint return begins in 1953 and ends in 1954, the taxable year of the deceased spouse covered by the joint return shall, for the purpose of determining the tax under section 400 and this section in respect of such joint return, be deemed to have ended on the date of the closing of the surviving spouse's taxable year.

(f) The fact that the taxable year is a period of less than 12 months resulting by reason of the death of the taxpayer does not prevent the application of Supplement T in the determination of the tax for such period.

(g) For treatment of taxable years beginning in 1953 and ending in 1954, see § 39.108-1.

§ 39.401 *Statutory provisions; tax under Supplement T · exemptions.*

SEC. 401. *Definition of "exemption"* As used in the table in section 400, the term "number of exemptions" means the number of the exemptions allowed under section 25 (b) as credits against net income for purpose of the normal tax and the surtax imposed by sections 11 and 12.

[Sec. 401 as added by sec. 102 (a), Rev. Act 1941; amended by sec. 104 (b), Rev. Act 1942; sec. 5 (a), Individual Income Tax Act 1944; sec. 102 (b) (10), Rev. Act 1945]

§ 39.401-1 *Rules for application of tables in section 400.* (a) The term "number of exemptions" means the number of exemptions allowed under section 25 (b) as credits against net income for the purpose of the normal tax and surtax imposed by sections 11 and 12. One exemption is allowed for the taxpayer; one exemption for his spouse if a joint return is made, or if a separate return is made by the taxpayer and his spouse has no gross income for the calendar year in which the taxable year of the taxpayer begins and is not the dependent of another taxpayer for such calendar year; and one exemption for each dependent whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than $600. Additional exemptions are allowed under section 25 (b) (1) (B) and (C) for a taxpayer or spouse who has attained the age of 65 years and for a blind taxpayer or blind spouse. See § 39.25-2. After the number of exemptions is ascertained, the tax under Supplement T for the taxable year is determined by reference to the table contained in section 400 applicable to such taxable year and by reference to the column of such table appropriate to such number of exemptions and, in certain cases, appropriate to either the status of the taxpayer (whether single, head of household, or married) or kind of return (whether separate or joint) or both. The tax is the amount in such column shown on the line appropriate to the taxpayer's adjusted gross income.

(b) The application of this section may be illustrated by the following examples:

Example (1). A, a married man whose duties as an employee require traveling away from his home, has as his sole gross income a salary of $5,000 for the calendar year 1952. His traveling expenses, including cost of meals and lodging, amount in such year to $750, and, hence, his adjusted gross income is $4,850. His wife, B, has as her sole income dividends of $85, and thus the aggregate adjusted gross income of A and B is $4,935. A has two dependent children neither of whom has any income. A and B file a joint return for 1952 on Form 1040, electing not to use the optional return Form 1040A. In such case four exemptions are allowable. The adjusted gross income falls within the tax bracket $4,900-$4,950. By referring to such tax bracket in Table II and to the column headed "4" therein, the tax is found to be $451.

Example (2). C, a married man, has as his sole income in 1952 wages of $4,000, and has two dependent children neither of whom has any income. His wife, D, has adjusted gross income of $400. C files a separate return for 1952 and is entitled to claim three exemptions. C's income falls within the tax bracket $4,600-$4,650, and hence, with three exemptions his tax is $533. No exemption is allowed with respect to D since D has gross income and a joint return was not filed.

Example (3). D, a married man with no dependents, attains the age of 65 years on September 1, 1952. The aggregate adjusted gross income of D and his wife for 1952 is $4,840. D and his wife file a joint return for 1952 and are entitled to three exemptions, one for each taxpayer and one additional exemption for D because of his age. Since the adjusted gross income of D and his wife falls within the tax bracket $4,800-$4,850, the tax on a joint return is $564.

§ 39.402 *Statutory provisions; tax under Supplement T; manner and effect of election.*

SEC. 402. *Manner and effect of election.* The election referred to in section 400 shall be exercised in the manner provided in regulations prescribed by the Commissioner with the approval of the Secretary. For cases in which election to take the standard deduction also constitutes an election to pay the tax imposed by this supplement, see section 23 (aa) (3) (D). For cases in which election to file a return without showing tax thereon constitutes an election to pay the tax imposed by this supplement, see section 51 (f). In the case of a head of a household electing to have his tax computed by the collector pursuant to the provisions of section 51 (f), the tax imposed by section 400 shall be computed without regard to the status of the taxpayer as a head of a household.

[Sec. 402 as added by sec. 102 (a), Rev. Act 1941; amended by sec. 5 (a), Individual Income Tax Act 1944; sec. 301 (b) (2), Rev. Act 1951]

§ 39.402-1 *Manner of election to compute tax under Supplement T*—(a) *In general.* The taxpayer elects to pay his income tax under Supplement T either by (1) filing a return of his gross income on Form 1040A, prescribed in § 39.51-2, or (2) by filing a return on Form 1040 and electing in such return, in the manner prescribed in paragraph (b) of § 39.23 (aa)-1, to take the standard deduction provided in section 23 (aa)

(b) *Husband and wife.* In the case of husband and wife, if the aggregate gross income of the spouses is less than $5,000, the election may be made by the filing of a return on Form 1040A, or by the filing of a return on Form 1040 and electing thereon to take the standard deduction. If one spouse has less than $5,000 gross income and the other spouse has gross income of $5,000 or more and the latter spouse, in filing his or her return, claims the standard deduction provided in section 23 (aa), then the former spouse may file on Form 1040A and such filing shall constitute an election by such spouse to pay the tax imposed under Supplement T. If, however, the spouse with gross income of $5,000 or more, in filing his or her return, does not elect to take such standard deduction, then the other spouse may not elect to pay the tax imposed by Supplement T.

(c) *Head of household.* In the case of a head of a household electing to make his return on Form 1040A, the tax imposed by section 400 shall be computed without regard to the status of the taxpayer as the head of a household. See § 39.51-2.

(d) *Revocability of election.* An election under Supplement T, or the making of a return without regard to Supplement T, for any taxable year may be changed under the same circumstances that an election to take, or not to take, the standard deduction may be changed. See § 39.23 (aa)-1 (d).

§ 39.403-404 *Statutory provisions; tax under Supplement T; credits; not allowed, taxpayers ineligible.*

SEC. 403. *Credits not allowed.* For credits against tax and against net income not allowed, in the case of a taxpayer who elects to pay the tax imposed by this supplement, because of the fact that such election constitutes an election to take the standard deduction, see section 23 (aa).

[Sec. 403 as added by sec. 102 (a), Rev. Act 1941; amended by sec. 5 (a), Individual Income Tax Act 1944]

SEC. 404. *Certain taxpayers ineligible.* This supplement shall not apply to a nonresident alien individual, to a citizen of the United States entitled to the benefits of section 251, to an estate or trust, or to an individual making a return for a period of less than twelve months on account of a change in the accounting period. For provisions making both husband and wife ineligible to elect to pay the tax imposed by this supplement if either does not elect to take the standard deduction, see section 23 (aa) (4).

[Sec. 404 as added by sec. 102 (a), Rev. Act 1941; amended by sec. 104 (c), Rev. Act 1942; sec. 102 (b), Rev. Act 1943; sec. 5 (a), Individual Income Tax Act 1944]

§ 39.404-1 *Taxpayers to whom Supplement T is inapplicable*—(a) *In general.* The following taxpayers are ineligible to file a return and pay the tax under Supplement T:

(1) A nonresident alien individual;

(2) A citizen of the United States entitled to the benefits of section 251,

(3) An estate or trust;

(4) An individual who makes a return for a period of less than 12 months on account of a change in the accounting period;

(5) An individual for whom a return is required for a fractional part of a year under section 146 (a)

(b) *Husband and wife.* For provisions making both husband and wife ineligible to elect to pay the tax under Supplement T if either spouse does not elect to take the standard deduction, see section 23 (aa) (4)

SUPPLEMENT U—TAXATION OF BUSINESS INCOME OF CERTAIN SECTION 101 ORGANIZATIONS

§ 39.421 *Statutory provisions; imposition of tax on business income of certain section 101 organizations.*

SEC. 421. *Imposition of tax*—(a) *In general.* There shall be levied, collected, and paid for each taxable year beginning after December 31, 1950—

(1) Upon the supplement U net income (as defined in subsection (c)) of every organization described in subsection (b) (1), a normal tax of 25 per centum of the supplement U net income, and a surtax of 22 per centum of the amount of the supplement U net income in excess of $25,000; except that (A) in the case of taxable years beginning before April 1, 1951, and ending after March 31, 1951, the normal tax shall be 28¾ per centum of the supplement U net income, and (B) in the case of taxable years beginning after March 31, 1951, and before April 1, 1954, the normal tax shall be 30 per centum of the supplement U net income.

(2) Upon the supplement U net income of every trust described in subsection (b) (2), a normal tax computed at the rate and in the manner provided in section 11 and a surtax computed at the rates and in the manner provided in section 12 (b). In making such computations for the purposes of this section, the term "the amount of the net income in excess of the credits against net income provided in section 25" as used in section 11 shall be read as "the amount of the supplement U net income" and the term "surtax net income" as used in section 12 (b) shall be read as "supplement U net income"

(b) *Organizations subject to tax*—(1) *Organizations taxable as corporations*—(A) *Organizations exempt under section 101 (1), (6), (7) and (14).* The taxes imposed by subsection (a) (1) shall apply in the case of any organization (other than a church, a convention or association of churches, or a trust described in paragraph (2)) which is exempt, except as provided in this supplement, from taxation under this chapter by reason of paragraph (1), (6), or (7) of section 101. Such taxes shall also apply in the case of a corporation described in section 101 (14) if the income is payable to an organization which itself is subject to the tax imposed by subsection (a) or to a church or to a convention or association of churches.

(B) *State colleges and universities.* The taxes imposed by subsection (a) (1) shall apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof or by any agency or instrumentality of any one or more governments or political subdivisions. Such taxes shall also apply in the case of any corporation wholly owned by one or more such colleges or universities.

(2) *Trusts taxable at individual rates.* The taxes imposed by subsection (a) (2) shall apply in the case of any trust which is exempt, except as provided in this supplement, from taxation under this chapter by reason of paragraph (6) of section 101 and which, if it were not for such exemption, would be subject to the provisions of supplement E.

(c) *Definition of Supplement U net income.* The term "Supplement U net income" of an organization means the amount by which its unrelated business net income (as defined in section 422) exceeds $1,000.

(d) *Foreign organizations.* The Supplement U net income of an organization described in subsection (b) (1) or (2) which is a foreign organization shall be its Supplement U net income derived from sources within the United States determined in accordance with the rules of section 119 and sections 212, 213 (a), 231 (c) and (d), and 232 (a).

[Sec. 421 as added by sec. 8, Current Tax Payment Act 1943; amended by sec. 1, Pub. Law 367 (80th Cong.); sec. 9, Pub. Law 384 (80th Cong.); sec. 301 (a), Rev. Act 1950; sec. 201 (d), Excess Profits Tax Act 1950; secs. 121 (e), 339 (a), Rev. Act 1951]

§ 39.421-1 *Imposition of tax*—(a) *Rates of tax.* Section 421 (a) imposes a tax upon the Supplement U net income of certain organizations otherwise exempt from Federal income tax by reason of section 101 (1) (6) (7) or (14) The taxes imposed by section 421 (a) also apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof or by any agency or instrumentality of any one or more governments or political subdivisions, and to any corporation wholly owned by one or more such colleges or universities. Under section 421 (a) (1), organizations described in section 421 (b) (1) (A) and in § 39.421-2 (a) (1) and organizations described in section 421 (b) (1) (B) and in § 39.421-2 (a) (2) are subject to—

(1) A normal tax of 25 percent on their Supplement U net income except that in the case of taxable years beginning before April 1, 1954, the normal tax shall be 30 percent of the Supplement U net income, and

(2) A surtax of 22 percent on the amount of such income in excess of $25,000.

Under section 421 (a) (2), trusts described in section 421 (b) (2) and paragraph (b) of § 39.421-2 are subject to tax at the individual rates prescribed in sections 11 and 12 (b) For the purpose of computing the tax imposed by section 11 and section 12 (b) the term "the amount of the net income in excess of the credits against net income provided in section 25" as used in section 11, and the term "surtax net income" as used in section 12 (b) shall each be read as "Supplement U net income" The credit of $100 against net income provided in section 163 (a) (1) in the case of a trust taxable under Supplement E is not allowed as a credit against Supplement U net income.

(b) *Definition of Supplement U net income.* The term "Supplement U net income" means the amount by which the unrelated business net income (as defined in section 422) of an organization exceeds $1,000.

§ 39.421-2 *Organizations subject to tax.* (a) (1) The taxes imposed by section 421 (a) (1) apply in the case of any organization (other than a church, a convention or association of churches, or a trust described in section 421 (b) (2) and in paragraph (b) of this section) which is exempt, except as provided in Supplement U, from taxation under chapter 1 by reason of paragraph (1), (6) or (7) of section 101. A corporation exempt from taxation under section 101 (14), holding property for an organization which itself is subject to the tax or for a church or a convention or association of churches, is also subject to the Supplement U tax under section 421 (a) (1)

(2) The taxes imposed by section 421 (a) (1) apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof or by any agency or instrumentality of any one or more governments or political subdivisions. Such taxes also apply in the case of any corporation wholly owned by one or more such colleges or universities. As here used, the word "government" includes any foreign government (to the extent not contrary to any treaty obligation of the United States) and all domestic governments (the United States and any of its Territories or possessions, any State, and the District of Columbia) Elementary and secondary schools operated by such governments are not subject to the Supplement U tax.

(3) Churches and associations or conventions of churches are exempt from the Supplement U tax. The exemption is applicable only to an organization which itself is a church or an association or convention of churches. Religious organizations, including religious orders, if not themselves churches or associations or conventions of churches, and all other organizations which are organized or operated under church auspices, are subject to the Supplement U tax, whether or not they carry out a religious, educational, or charitable function approved by a church. For example, an incorporated university exempt from tax under section 101 (6) is subject to the Supplement U tax whether or not it was organized by or is operated under the auspices of a church.

(b) The taxes imposed by section 421 (a) (2) shall apply in the case of any trust which is exempt, except as provided in Supplement U, from taxation under chapter 1 by reason of section 101 (6) and which, if it were not for such exemption under section 101 (6) would be subject to the provisions of Supplement E of such chapter.

§ 39.421-3 *Provisions generally applicable to Supplement U tax*—(a) *Assessment and collections.* Since the taxes imposed by section 421 are taxes imposed by chapter 1 of the Internal Revenue Code, all provisions of law and of the regulations in this part applicable to the taxes imposed by chapter 1 are applicable to the assessment and collection of the taxes imposed by section 421. For the requirement as to the filing of returns, see paragraph (b) of this section. Organizations subject to the tax imposed by section 421 (a) (1) are subject to the same provisions, including penalties, as are provided in the case of the income tax of other corporations. In the case of a trust subject to the tax imposed by section 421 (a) (2) the fiduciaries for such trust are subject to the same provisions, including penalties, as are applicable to fiduciaries in the case of the income tax of other trusts. See sections 52, 53, 56, and 142, and the regulations prescribed thereunder, with respect to provisions applicable to returns and payment of tax.

(b) *Returns.* The return of Supplement U tax shall be on Form 990-T. The return shall be filed for each taxable year by every organization, otherwise exempt from tax under section 101 (1) (6) (7) or (14) and subject to the Supplement U tax, which has gross income, included in computing unrelated business net income for such taxable year, of $1,000 or more. A return shall also be filed for each taxable year by every governmental college or university and by every corporation wholly owned by such a college or university, which is subject to the Supplement U tax and which has gross income, included in computing unrelated business net income for such taxable year, of $1,000 or more. The filing of Form 990-T does not relieve the organization of the duty of filing other returns required under chapter 1 of the Internal Revenue Code.

(c) *Taxable years, method of accounting, etc.* The taxable year (fiscal year or calendar year, as the case may be) of an organization shall be determined without regard to the fact that such organization may have been exempt from tax during any prior period. See sections 41 and 48, and the regulations thereunder. Similarly, in computing unrelated business net income, the determination of the taxable year for which an item of income or expense is taken into account shall be made under the provisions of sections 41, 42, and 43, and the regulations thereunder, whether or not the item arose during a taxable year beginning before, on, or after the effective date of the provisions imposing a tax upon Supplement U net income. If a method for treating bad debts was selected in a return of income (other than an information return) for a previous taxable year, the taxpayer must follow such method in its returns under Supplement U, unless such method is changed in accordance with the provisions of § 39.23 (k)-1. A taxpayer which has not previously selected a method for treating bad debts may, in its first return under Supplement U, exercise the option granted in § 39.23 (k)-1.

(d) *Foreign tax credit.* See section 424 for provisions applicable to the credit for foreign taxes provided in section 131.

§ 39.422 *Statutory provisions; unrelated business net income of certain section 101 organizations.*

SEC. 422. *Unrelated business net income*—(a) *Definition.* The term "unrelated business net income" means the gross income derived by any organization from any unrelated trade or business (as defined in subsection (b)) regularly carried on by it, less the deductions allowed by section 23 which are directly connected with the carrying on of such trade or business, subject to the following exceptions, additions, and limitations:

(1) There shall be excluded all dividends, interest, and annuities, and all deductions directly connected with such income.

(2) There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or net income from the property, and all deductions directly connected with such income.

(3) There shall be excluded all rents from real property (including personal property leased with the real property), and all deductions directly connected with such rents.

(4) Notwithstanding paragraph (3), in the case of a Supplement U lease (as defined in section 423 (a)) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 423 (d) (1) and there shall be allowed, as a deduction, the amount ascertained under section 423 (d) (2).

(5) There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. This paragraph shall not apply with respect to the cutting of timber which is considered, upon the application of section 117 (k) (1), as a sale or exchange of such timber.

(6) The net operating loss deduction provided in section 23 (s) shall be allowed, except that—

(A) The net operating loss for any taxable year, the amount of the net operating loss carry-back or carry-over to any taxable year, and the net operating loss deduction for any taxable year shall be determined under section 122 without taking into account any amount of income or deduction which is excluded under this supplement in computing the unrelated business net income; and

(B) The terms "preceding taxable year" and "preceding taxable years" as used in section 122 shall not include any taxable year for which the organization was not subject to the provisions of this supplement.

(7) There shall be excluded all income derived from research for (A) the United States, or any of its agencies or instrumentalities, or (B) any State or political subdivision thereof; and there shall be excluded all deductions directly connected with such income.

(8) (A) In the case of a college, university, or hospital, there shall be excluded all income derived from research performed for any person, and all deductions directly connected with such income.

(B) In the case of an organization operated primarily for the purposes of carrying on fundamental research the results of which are freely available to the general public, there shall be excluded all income derived from research performed for any person, and all deductions directly connected with such income.

(9) (A) In the case of any organization described in section 421 (b) (1), the so-called "charitable contribution" deduction allowed by section 23 (q) shall be allowed (whether or not directly connected with the carrying on of the trade or business), but shall not exceed 5 per centum of the unrelated business net income computed without the benefit of this subparagraph.

(B) In the case of any trust described in section 421 (b) (2), the so-called "charitable contribution" deduction allowed by section 23 (o) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 23 (o) shall be considered as a gift or contribution. The deduction allowed by this subparagraph shall not exceed 15 per centum of the unrelated business net income computed without the benefit of this subparagraph.

If a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business net income shall, subject to the exceptions, additions and limitations contained in paragraphs (1) through (9) above, include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income. If the taxable year of the organization is different from that of the partnership, the amounts to be so included or deducted in computing the unrelated business net income shall be based upon the income and deductions of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1951) ending within or with the taxable year of the organization. In the case of an organization described in section 3813 (a) (2) which is a member of a partnership all of whose members are organizations described in section 3813 (a) (2), if a trade or business regularly carried on by such partnership is an unrelated trade or business with respect to such organization, such organization shall, for taxable years beginning before January 1,

1954, be allowed a deduction in an amount equal to the portion of the gross income of such partnership from such unrelated trade or business which such organization is required (by a provision of a written contract executed by such organization prior to January 1, 1950, which provision expressly deals with the disposition of the gross income of the partnership) to pay within the taxable year in discharge of indebtedness incurred by such organization in acquiring its share of such trade or business, or to irrevocably set aside within the taxable year for the discharge of such indebtedness (to the extent that such amount has been so paid or set aside) if (i) such partnership was formed prior to January 1, 1950, for the purpose of carrying on such trade or business, and (ii) substantially all the assets used in carrying on such trade or business were acquired by it or by its members prior to such date. As used in the preceding sentence, the word "indebtedness" does not include indebtedness incurred after January 1, 1950.

(b) *Unrelated trade or business.* The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 421 (a), any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 101 (or, in the case of an organization described in section 421 (b) (1) (B), to the exercise or performance of any purpose or function described in section 101 (6)), except that such term shall not include any trade or business—

(1) In which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) Which is carried on, in the case of an organization described in section 101 (6) or in the case of a college or university described in section 421 (b) (1) (B), by the organization primarily for the convenience of its members, students, patients, officers, or employees; or

(3) Which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

The term "unrelated trade or business" means, in the case of a trust computing its unrelated business net income under this section for the purpose of section 162 (g) (1), any trade or business regularly carried on by such trust or by a partnership of which it is a member. If a publishing business carried on by an organization during a taxable year beginning before January 1, 1953, is, without regard to this sentence, an unrelated trade or business, but before the beginning of the third succeeding taxable year the business is carried on by it (or by a successor who acquired such business in a liquidation which would constitute a tax-free exchange under section 112 (b) (6)) in such manner that the conduct thereof is substantially related to the exercise or performance by such organization (or such successor) of its educational or other purpose or function described in section 101 (6), such publishing business shall not be considered, for the taxable year, as an unrelated trade or business.

[Sec. 422 as added by sec. 301 (a), Rev. Act 1950; amended by secs. 339 (b), 347, 348, Rev. Act 1951]

§ 39.422-1 *Definition of unrelated business net income*—(a) *General rule.* The unrelated business net income which is subject to the Supplement U tax is the gross income, derived by any organization to which Supplement U applies, from any unrelated trade or business regularly carried on by it, less the deductions allowed by section 23 of the Code which are directly connected with the carrying on of such trade or business, subject to certain exceptions, additions, and limitations referred to below. In the case of an organization which regularly carries on two or more unrelated businesses, its unrelated business net income is the aggregate of its gross income from all such unrelated businesses, less the aggregate of the deduction allowed with respect to all such unrelated businesses. For provisions generally applicable to the Supplement U tax, see § 39.421-3, and for rules applicable to the determination of the adjusted basis of property, see paragraph (a) of § 39.423-3.

(b) *Exceptions, additions, and limitations.* Whether a particular item of income falls within any of the exceptions, additions, and limitations provided in section 422 shall be determined by all the facts and circumstances of each case. For example, if a payment termed "rent" by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or a joint venturer, such payment is not within the exception for rent. The exceptions, additions, and limitations provided in section 422 are as follows:

(1) *Dividends, interest and annuities.* All dividends, interest, and annuities, and the deductions directly connected therewith, shall be excluded in computing unrelated business net income.

(2) *Royalties.* Royalties, including overriding royalties, and all deductions directly connected with such income shall be excluded in computing unrelated business net income. Mineral royalties shall be excluded whether measured by production or by gross or net income from the mineral property. However, where an organization owns a working interest in a mineral property, and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded. In-oil payments shall be treated in the same manner as royalty payments for the purpose of computing unrelated business net income.

(3) *Rents.* (i) Rents from real property (including personal property leased with the real property) and the deductions directly connected therewith shall also be excluded in computing unrelated business net income, except that certain rents from, and certain deductions in connection with, a Supplement U lease (as defined in section 423 (a)) shall be included in computing unrelated business net income. See §§ 39.423-3 and 39.423-4.

(ii) Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, or for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rentals from real estate. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in an office building, etc., are generally rentals from real estate.

(4) *Gains and losses from the sale, etc., of property.* There shall also be excluded from the computation of unrelated business net income gains or losses from the sale, exchange, or other disposition of property other than (i) stock in trade or other property of a kind which would properly be included in the inventory of the organization if on hand at the close of the taxable year, or (ii) property held primarily for sale to customers in the ordinary course of the trade or business. This exclusion does not apply with respect to the cutting of timber which is considered, upon the application of section 117 (k) (1), as a sale or exchange of such timber. The exclusion under section 422 (a) (5) applies with respect to gains and losses from involuntary conversions, casualties, etc.

(5) *Net operating losses.* The net operating loss deduction provided in section 23 (s) shall be allowed in computing unrelated business net income. However, the net operating loss carry-back or carry-over (from a taxable year for which the taxpayer is subject to the provisions of Supplement U) shall be determined under section 122 without taking into account any amount of income or deduction which is not included under Supplement U in computing unrelated business net income. For example, a loss attributable to an unrelated trade or business shall not be diminished by reason of the receipt of dividend income. For the purpose of computing the net operating loss deduction, the terms "preceding taxable year" and "preceding taxable years" as used in section 122 shall not include any taxable year for which the organization was not subject to the provisions of Supplement U. Thus, if the organization was not subject to the provisions of Supplement U for the immediately preceding taxable year, the net operating loss is not a carry-back to any preceding taxable year, and the net operating loss carry-over to succeeding taxable years is not reduced by the net income for any preceding taxable year. A net operating loss carry-back or carry-over shall be allowed only from a taxable year for which the taxpayer is subject to the provisions of Supplement U.

(6) *Research.* (i) Income derived from research for the United States or any of its agencies or instrumentalities

or a State or political subdivision thereof, and all deductions directly connected with such income, shall be excluded in computing unrelated business net income.

(ii) In the case of a college, university, or hospital, all income derived from research performed for any person and all deductions directly connected with such income shall be excluded in computing unrelated business net income.

(iii) In the case of an organization operated primarily for the purpose of carrying on fundamental research (as distinguished from applied research) the results of which are freely available to the general public, all income derived from research performed for any person and all deductions directly connected with such income shall be excluded in computing unrelated business net income.

(iv) For the purpose of this section, the term "research" does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc. The term "fundamental research" does not include research carried on for the primary purpose of commercial or industrial application.

(7) *Charitable, etc., contributions.* (i) In computing the unrelated business net income of a trust described in section 421 (b) (2) or of an organization described in section 421 (b) (1) there shall be deducted from gross income the amount allowed by section 23 (o) or 23 (q) whichever is applicable, whether or not the contribution is directly connected with the carrying on of the trade or business. This deduction shall be limited to 15 percent, if computed under section 23 (o) or 5 percent, if computed under section 23 (q) of the unrelated business net income computed without benefit of such deduction. In the case of a trust described in section 421 (b) (2) distributions made pursuant to the trust instrument to a beneficiary described in section 23 (o) shall be treated in the same manner as gifts or contributions.

(ii) The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a university exempt from tax under section 101 (6) operating an unrelated business, shall be allowed a deduction, not in excess of 5 percent of its unrelated business net income, for gifts or contributions to another university for educational work but shall not be allowed any deduction for amounts expended in administering its own educational program.

§ 39.422-2 *Organizations that are members of partnerships*—(a) *In general.* In the event an organization to which Supplement U applies is a member of a partnership regularly engaged in a trade or business which is an unrelated trade or business with respect to such organization, the organization shall include in computing its unrelated business net income so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto. For this purpose, both the gross income and the deductions shall be computed with the necessary adjustments for the exceptions, additions, and limitations referred to in section 422 (a) and in § 39.422-1. For example, if an exempt educational institution is a partner in a partnership which operates a factory and if such partnership also holds stock in a corporation, the exempt organization shall include in computing its unrelated business net income its share of the gross income from the operation of the factory, but not its share of any dividends received by the partnership from the corporation. If the taxable year of the organization differs from that of the partnership, the amounts included or deducted in computing unrelated business net income shall be based upon the income and deductions of the partnership for each taxable year of the partnership ending within or with the taxable year of the organization.

(b) *Special rule.* For a special rule, applicable only with respect to taxable years beginning before January 1, 1954, with respect to unrelated trades or businesses carried on in partnership by certain educational organizations described in section 3813 (a) (2) see the last two sentences of section 422 (a).

§ 39.422-3 *Definition of unrelated trade or business*—(a) *In general.* (1) As used in section 422 (a) the term "unrelated business net income" includes only income from an unrelated trade or business regularly carried on, and the term "trade or business" has the same meaning as it has in section 23 (a) (1)

(2) The income of an exempt organization is subject to the Supplement U tax only if two conditions are present with respect to such income. The first condition is that the income must be from a trade or business which is regularly carried on by the organization. The second condition is that the trade or business must not be substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 101, or, in the case of an organization described in section 421 (b) (1) (B) (governmental colleges, etc.) to the exercise or performance of any purpose or function described in section 101 (6) Whether or not an organization is subject to the Supplement U tax shall be determined by the application of these tests to the particular circumstances involved in each individual case. For certain exceptions from the term "unrelated trade or business", see paragraph (b) of this section.

(3) A trade or business is regularly carried on when the activity is conducted with sufficient consistency to indicate a continuing purpose of the organization to derive some of its income from such activity. An activity may be regularly carried on even though its performance is infrequent or seasonal.

(4) Ordinarily, a trade or business is substantially related to the activities for which an organization is granted exemption if the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. In the usual case the nature and size of the trade or business must be compared with the nature and extent of the activities for which the organization is granted exemption in order to determine whether the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. For example, the operation of a wheat farm is substantially related to the exempt activity of an agricultural college if the wheat farm is operated as a part of the educational program of the college, and is not operated on a scale disproportionately large when compared with the educational program of the college. Similarly, a university radio station or press is considered a related trade or business if operated primarily as an integral part of the educational program of the university, but is considered an unrelated trade or business if operated in substantially the same manner as a commercial radio station or publishing house. A trade or business not otherwise related does not become substantially related to an organization's exempt purpose merely because incidental use is made of the trade or business in order to further the exempt purpose. For example, the manufacture and sale of a product by an exempt college would not become substantially related merely because students as part of their educational program perform clerical or bookkeeping functions in the business. In some cases, the business may be substantially related because it is a necessary part of the exempt activity. For example, in the case of an organization exempt under section 101 (6) and engaged in the rehabilitation of handicapped persons, the business of selling articles made by such persons as a part of their rehabilitation training would not be considered an unrelated business since such business is a necessary part of the rehabilitation program.

(b) *Exceptions.* Section 422 (b) specifically states that the term "unrelated trade or business" does not include—

(1) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) Any trade or business carried on by an organization exempt under section 101 (6) or by a governmental college or university described in section 421 (b) (1) (B) primarily for the convenience of its members, students, patients, officers, or employees; or

(3) Any trade or business which consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.

An example of the operation of the first of the exceptions mentioned above would be an exempt orphanage operating a retail store and selling to the general public, where substantially all the work in carrying on such business is performed for the organization by volunteers without compensation. An example of the second limitation would be a laundry operated by a college for the purpose of laundering dormitory linens and the clothing of students. The third exception applies to so-called "thrift shops" operated by a tax-exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, etc., to be sold to the general public with the proceeds going to the exempt organization.

(c) *Special rule respecting publishing businesses.* For a special rule, applicable only with respect to taxable years beginning before January 1, 1953, with respect to publishing businesses carried on by an organization, see section 422 (b)

§ 39.423 *Statutory provisions; treatment of Supplement U lease in determination of unrelated business net income.*

SEC. 423. *Supplement U lease*—(a) *Definition of supplement U lease.* The term "supplement U lease" means a lease for a term of more than five years of real property by an organization (or by a partnership of which it is a member), if at the close of the lessor's taxable year there is a supplement U lease indebtedness (as defined in subsection (b)) with respect to such property. In computing the term of a lease which contains an option for renewal or extension, the term of such lease shall be considered as including any period for which such option may be exercised; and the term of any lease made pursuant to an exercise of such option shall include the period during which the prior lease was in effect. If real property is acquired subject to a lease, the term of such lease shall be considered to begin on the date of such acquisition. No lease shall be considered a supplement U lease if (A) such lease is entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 101, or (B) the lease is of premises in a building primarily designed for occupancy, and occupied, by the organization. If a lease for more than five years to a tenant is for only a portion of the real property, and space in the real property is rented during the taxable year under a lease for not more than five years to any other tenant of the organization, leases of the real property for more than five years shall be considered as supplement U leases during the taxable year only if—

(1) The rents derived from the real property during the taxable year under such leases represent 50 per centum or more of the total rents derived during the taxable year from the real property; or the area of the premises occupied under such leases represents, at any time during the taxable year, 50 per centum or more of the total area of the real property rented at such time; or

(2) The rent derived from the real property during the taxable year from any tenant under such a lease, or from a group of tenants (under such leases) who are (A) members of an affiliated group (as defined in section 141) or (B) partners, represents more than 10 per centum of the total rents derived during the taxable year from such property; or the area of the premises occupied by any one such tenant, or by any such group of tenants, represents at any time during the taxable year more than 10 per centum of the total area of the real property rented at such time.

(b) *Supplement U lease indebtedness.* The term "supplement U lease indebtedness" means, with respect to any real property leased for a term of more than five years, the unpaid amount of—

(1) The indebtedness incurred by the lessor in acquiring or improving such property;

(2) The indebtedness incurred prior to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(3) The indebtedness incurred subsequent to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

Where real property is acquired subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien shall be considered (whether the acquisition was by gift, devise, or purchase) as an indebtedness of the lessor incurred in acquiring such property even though the lessor did not assume or agree to pay such indebtedness, except that where real property was acquired by gift, bequest, or devise prior to July 1, 1950, subject to a mortgage or other similar lien, the amount of such mortgage or other similar lien shall not be considered as an indebtedness of the lessor incurred in acquiring such property. Where real property was acquired by gift, bequest, or devise prior to July 1, 1950, subject to a lease requiring improvements in such property upon the happening of stated contingencies, indebtedness incurred in improving such property in accordance with the terms of such lease shall not be considered as an indebtedness for purposes of this subsection. In the case of a corporation described in section 101 (14), all of the stock of which was acquired prior to July 1, 1950, by an organization described in paragraph (1), (6), or (7) of section 101 (and more than one-third of such stock was acquired by such organization by gift or bequest), any indebtedness incurred by such corporation prior to July 1, 1950, and any indebtedness incurred by such corporation on or after such date in improving real property in accordance with the terms of a lease entered into prior to such date, shall not be considered as an indebtedness with respect to such corporation or such organization for purposes of this subsection. In determining the amount of the supplement U lease indebtedness where only a portion of the real property is subject to a supplement U lease, proper allocation to the premises covered by such lease shall be made of the indebtedness incurred by the lessor with respect to the real property.

(c) *Personal property leased with real property.* For the purposes of this section, the term "real property" and the term "premises" include personal property of the lessor leased by it to a lessee of its real estate if the lease of such personal property is made under, or in connection with, the lease of such real estate.

(d) *Treatment of Supplement U lease rents and deductions.* In computing under section 422 (a) the unrelated business net income for any taxable year—

(1) *Percentage of rents taken into account.* There shall be included with respect to each Supplement U lease, as an item of gross income derived from an unrelated trade or business, an amount which is the same percentage (but not in excess of 100 per centum) of the total rents derived during the taxable year under such lease as (A) the Supplement U lease indebtedness, at the close of the taxable year, with respect to the premises covered by such lease is of (B) the adjusted basis, at the close of the taxable year, of such premises.

(2) *Percentage of deductions taken into account.* There shall be allowed with respect to each Supplement U lease, as a deduction to be taken into account in computing unrelated business net income, an amount which is the same percentage (but not in excess of 100 per centum) of the sum determined under paragraph (3) as the amount determined under clause (A) of paragraph (1) is of the amount determined under clause (B) of such paragraph.

(3) *Deductions allowable.* The sum referred to in paragraph (2) is the sum of the following deductions allowable under section 23:

(A) Taxes and other expenses paid or accrued during the taxable year upon or with respect to the real property subject to the Supplement U lease.

(B) Interest paid or accrued during the taxable year on the Supplement U lease indebtedness.

(C) A reasonable allowance for exhaustion, wear and tear (including a reasonbale allowance for obsolescence) of the real property subject to such lease.

Where only a portion of the real property is subject to the Supplement U lease, there shall be taken into account under subparagraph (A), (B), or (C) only those amounts which are properly allocable to the premises covered by such lease.

[Sec. 423 as added by sec. 301 (a), Rev. Act 1950]

§ 39.423-1 *Definition of Supplement U lease*—(a) *In general.* The term "Supplement U lease" means any lease, with certain exceptions discussed in paragraph (c) of this section, for a term of more than five years of real property by an organization subject to Supplement U (or by a partnership of which it is a member) if at the close of the organization's taxable year there is a Supplement U lease indebtedness as defined in section 423 (b) and § 39.423-2, with respect to such property. For the purpose of section 423, the term "real property" and the term "premises" include personal property of the lessor tax-exempt organization leased by it to a lessee of its real estate if the lease of such personal property is made under, or in connection with, the lease of such real estate. For amounts of Supplement U rents and deductions to be included in computing unrelated business net income, see § 39.423-3.

(b) *Special rules.* (1) In computing the term of the lease, the period for which a lease may be renewed or extended by reason of an option contained therein shall be considered as part of the term. For example, a 3-year lease with an option for renewal for another such period is considered a lease for a term of six years. Another example is the case of a 1-year lease with option of renewal for another such term, where the parties at the end of each year renew the arrangement. In this case, dur-

ing the fifth year (but not during the first four years) the lease falls within the 5-year rule, since the lease then involves five years and there is an option for the sixth year. In determining the term of the lease, an option for renewal of the lease is taken into account whether or not the exercise of the option depends upon conditions or contingencies.

(2) If the property is acquired subject to a lease, the term of such lease shall be considered to begin on the date of such acquisition. For example, if an exempt organization purchases, in whole or in part with borrowed funds, real property subject to a 10-year lease which has three years left to run, and such lease contains no right of renewal or extension, the lease shall be considered a 3-year lease and hence does not meet the definition of a Supplement U lease in section 423 (a) and paragraph (a) of this section. However, if this lease contains an option to renew for a period of three years or more, it is a Supplement U lease.

(c) *Exceptions.* (1) A lease shall not be considered a Supplement U lease if such lease is entered into primarily for a purpose which is substantially related (aside from the need of such organization for income or funds, or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption. For example, where a tax-exempt hospital leases real property owned by it to an association of doctors for use as a clinic, the rents derived under such lease would not be included in computing unrelated business net income if the clinic is substantially related to the carrying on of hospital functions. See § 39.422-3 for principles applicable in determining whether there is a substantial relationship to the exempt purposes of an organization.

(2) A lease is not a Supplement U lease if the lease is of premises in a building primarily designed for occupancy and occupied by the tax-exempt organization.

(3) If a lease for more than five years to a tenant is for only a portion of the real property, and space in the real property is rented during the taxable year under a lease for not more than 5 years to any other tenant of the tax-exempt organization, leases of the real property for more than five years shall be considered as Supplement U leases during the taxable year only if—

(i) The rents derived from the real property during the taxable year under such leases represent 50 percent or more of the total rents derived during the taxable year from the real property; or the area of the premises occupied under such leases represents, at any time during the taxable year, 50 percent or more of the total area of the real property rented at such time; or

(ii) The rent derived from the real property during the taxable year from any tenant under such a lease, or from a group of tenants (under such leases) who are either members of an affiliated group (as defined in section 141) or are partners, represents more than 10 percent of the total rents derived during the taxable year from such property; or the area of the premises occupied by any one such tenant, or by any such group of tenants, represents at any time during the taxable year more than 10 percent of the total area of the real property rented at such time.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example. In 1952 an educational organization, which is on the calendar year basis, begins the erection of an 11-story apartment building using funds borrowed for that purpose, and immediately leases for a 10-year term the first floor to a real estate development company to sublet for stores and shops. As fast as the new apartments are completed, they are rented on an annual basis. At the end of 1957 all except the tenth and eleventh floors are rented. These two floors are completed during 1958 and rented. Assume that for 1952 and each subsequent taxable year through 1957, and for the taxable year 1961, the gross rental for the first floor represents more than 10 percent of the total gross rents derived during the taxable year from the building. Under this set of facts the 10-year lease of the first floor would be considered to be a Supplement U lease for all except the taxable years 1959, 1960, and 1962.

§ 39.423-2 *Supplement U lease indebtedness*—(a) *Definition.* The term "Supplement U lease indebtedness" means, with respect to any real property leased by a tax-exempt organization for a term of more than five years, the unpaid amount of—

(1) The indebtedness incurred by the lessor tax-exempt organization in acquiring or improving such property;

(2) The indebtedness incurred by the lessor tax-exempt organization prior to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(3) The indebtedness incurred by the lessor tax-exempt organization subsequent to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of the indebtedness was reasonably forseeable at the time of such acquisition or improvement.

See paragraph (f) of this section with respect to subsidiary corporations.

(b) *Examples.* The rules of paragraph (a) of this section respecting Supplement U leases also cover certain cases where the leased property itself is not subject to an indebtedness. For example, they apply to cases such as the following:

Example (1). A university pledges some of its investment securities with a bank for a loan and uses the proceeds of such loan to purchase (either directly or through a subsidiary corporation) a building, which building is subject to a lease that then has more than five years to run. This would be an example of a Supplement U lease indebtedness incurred prior to the acquisition of the property which would not have been incurred but for such acquisition.

Example (2). If the building itself in example (1) in this paragraph is later mortgaged to raise funds to release the pledged securities, the lease would continue to be a Supplement U lease.

Example (3). If a scientific organization mortgages its laboratory building to replace working capital used in remodeling another one of its buildings or a building held by its subsidiary corporation, which other building is free of indebtedness and is subject to a lease that then has more than five years to run, the lease would be a Supplement U lease inasmuch as the indebtedness though incurred subsequent to the improvement of such property would not have been incurred but for such improvement, and the incurrence of the indebtedness was reasonably forseeable when, to make such improvement, the organization reduced its working capital below the amount necessary to continue current operations.

(c) *Lease of part of property.* Where only a portion of the real property is subject to a Supplement U lease, proper allocation of the indebtedness applicable to the whole property must be made to the premises covered by the lease.

(d) *Property acquired subject to lien.* Where real property is acquired subject to a mortgage or similar lien, whether the acquisition be by gift, bequest, devise, or purchase, the amount of the indebtedness secured by such mortgage or lien is a Supplement U lease indebtedness (unless paragraph (e) (1) of this section applies) even though the lessor does not assume or agree to pay the indebedness. For example, a university pays $100,000 for real estate valued at $300,000 and subject to a $200,000 mortgage. For the purpose of the Supplement U tax, the result is the same as if $200,000 of borrowed funds had been used to buy the property.

(e) *Exceptions.* (1) Where real property was acquired by gift, bequest, or devise, before July 1, 1950, subject to a mortgage or other similar lien, the amount of such mortgage or other similar lien shall not be considered as an indebtedness of the lessor tax-exempt organization incurred in acquiring such property. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(2) Where real property was acquired by gift, bequest, or devise, before July 1, 1950, subject to a lease requiring improvements in such property upon the happening of stated contingencies, indebtedness incurred in improving such property in accordance with the terms of such lease shall not be considered as indebtedness described in section 423 (b) and in this section. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(3) In the case of a corporation described in section 101 (14) all of the stock of which was acquired before July 1, 1950, by an organization described in paragraph (1), (6) or (7) of section 101 (and more than one-third of such stock was acquired by such organization by gift or bequest), any indebtedness incurred by such corporation before July 1, 1950, and any indebtedness incurred by such corporation on or after such

date in improving real property in accordance with the terms of a lease entered into before such date, with respect to either such section 101 (14) corporation or such section 101 (1) (6), or (7) organization, shall not be considered an indebtedness described in section 423 (b) and in this section.

(f) *Subsidiary corporations.* The provisions of section 423 are applicable whether or not a subsidiary corporation of the type exempt under section 101 (14) is availed of in making the Supplement U lease. For example, assume a parent organization borrows funds to purchase realty and sets up a separate section 101 (14) corporation as a subsidiary to hold the property. Such subsidiary corporation leases the property for a period of more than five years, collects the rents and pays over all of the income, less expenses, to the parent organization, the parent organization being liable for the indebtedness. Under these assumed facts, the lease by the section 101 (14) subsidiary corporation would be a Supplement U lease with respect to such subsidiary corporation, and the rental income would be subject to the tax, whether or not the subsidiary itself assumes the indebtedness and whether or not the property is subject to the indebtedness.

§ 39.423-3 *Treatment of rent from Supplement U lease*—(a) *General rule.* There shall be included with respect to each Supplement U lease, as an item of gross income derived from an unrelated trade or business, an amount which is the same percentage (but not in excess of 100 percent) of the total rents derived during the taxable year under such lease as—

(1) The amount of the Supplement U lease indebtedness at the close of the taxable year of the lessor tax-exempt organization, with respect to the premises covered by such lease, is of

(2) The adjusted basis of such premises at the close of such taxable year.

The basis (unadjusted) of property is determined under section 113 (a) and the adjusted basis of property is determined under section 113 (b) The determination of the adjusted basis of property is not affected by the fact that the organization was exempt from tax for prior taxable years. Proper adjustment must be made under section 113 (b) for the entire period since the acquisition of the property. Thus, adjustment must be made for depreciation for all prior taxable years whether or not the organization was exempt from tax for any of such years. Similarly for taxable years during which the organization is subject to Suplement U, the fact that only a portion of the deduction for depreciation is taken into account under section 423 (d) does not affect the amount of the adjustment for depreciation.

(b) *Examples.* The application of this section may be illustrated by the following examples, in each of which it is assumed that the taxpayer makes its returns under Supplement U on the basis of the calendar year, and that the lease is not substantially related to the purpose for which the organization is granted exemption from tax.

Example (1). Assume that a tax-exempt educational organization purchased property in 1942 for $600,000, using borrowed funds, and leased the building for a period of 20 years. Assume further that the adjusted basis of such building at the close of 1952 is $500,000. If, at the close of 1952, $200,000 of the indebtedness incurred to acquire the property remains outstanding, since this is two-fifths of the adjusted basis of the building at the close of 1952, two-fifths of the gross rental received from the building during 1952 shall be included as an item of gross income in computing unrelated business net income. If, at the close of a subsequent taxable year, the outstanding indebtedness is $100,000 and the adjusted basis of the building is $400,000, one-fourth of the gross rental for such taxable year shall be included as an item of gross income in computing unrelated business net income for such taxable year.

Example (2). Assume that a tax-exempt organization owns a 4-story building, that in 1952 it borrows $100,000 which it uses to improve the whole building, and that it thereafter in 1952 rents the first floor of the building under a 6-year lease at a rental of $4,000 a year. The second, third, and fourth floors of the building are leased on a yearly basis during 1952. Assume, also, that the adjusted basis of the real property at the end of 1952 (after reflecting the expenditures for improving the building) is $200,000, allocable equally to each the 4 stories. Under these facts, only one-fourth of the real property is subject to a Supplement U lease. The percentage of the rent under such lease which is taken into account is determined by the ratio which the allocable part of the Supplement U lease indebtedness bears to the allocable part of the adjusted basis of the real property, that is, the ratio which one-fourth of the $100,000 of Supplement U lease indebtedness outstanding at the close of 1952, or $25,000, bears to one-fourth of the adjusted basis of the Supplement U lease premises at the close of 1952, or $50,000. The percentage of rent which is Supplement U lease income for 1952 is, therefore, one-half (the ratio of $25,000 to $50,000) of $4,000, or $2,000, and this amount of $2,000 is considered an item of gross income derived from an unrelated trade or business.

§ 39.423-4 *Percentage of deductions taken into account.* (a) The same percentage is used in determining both the portion of the rent and the portion of the deductions taken into account with respect to the Supplement U lease in computing unrelated business net income. See § 39.423-3 for the determination of such percentage. Such percentage is applicable only to the sum of the following deductions allowable under section 23:

(1) Taxes and other expenses paid or accrued during the taxable year upon or with respect to the real property subject to the Supplement U lease;

(2) Interest paid or accrued during the taxable year on the Supplement U lease indebtedness;

(3) A reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) of the real property subject to such lease.

Where only a portion of the real property is subject to the Supplement U lease, there shall be taken into account only those amounts of the above-listed deductions which are properly allocable to the premises covered by such lease.

(b) The deductions allowable under section 423 (d) and under paragraph (a) of this section with respect to a Supplement U lease are not limited by the amount included in gross income with respect to the rent from such lease, but any excess of such deductions over such gross income shall be applied against other items of gross income in computing unrelated business net income taxable under section 421 (a)

(c) The application of this section may be illustrated by the following example:

Example. Assume the same facts as those in example (1) in paragraph (b) of § 39.423-3. Assume also that for 1952 the organization pays taxes of $4,000 on the property, interest of $6,000 on its Supplemnt U lease indebtedness, and that the depreciation allowable for 1952 under section 23 (1) is $10,000. Under the facts set forth in such example (1) and in this example, the deductions to be taken into account for 1952 in computing unrelated business net income would be two-fifths of the total of the deductions of $20,000, that is, $8,000.

§ 39.424 *Statutory provisions; credit for taxes of foreign countries and possessions of the United States.*

SEC. 424. *Taxes of foreign countries and possessions of the 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 an organization subject to the tax imposed by section 421 (a) to the extent provided in section 131; and in the case of the tax imposed by section 421 (a), the term "normal-tax net income" and the term "net income" as used in section 131 shall be read as "Supplement U net income"

[Sec. 424 as added by sec. 301 (a), Rev. Act 1950]

SUBPART D—TAX ON SELF-EMPLOYMENT INCOME (SUBCHAPTER E, CHAPTER 1, INTERNAL REVENUE CODE)

§ 39.480 *Statutory provisions; rate of tax on self-employment income.*

SEC. 480. *Rate of tax.* In addition to other taxes, there shall be levied, collected, and paid for each taxable year beginning after December 31, 1950, upon the self-employment income of every individual, a tax as follows:

(1) In the case of any taxable year beginning after December 31, 1950, and before January 1, 1954, the tax shall be equal to 2¼ per centum of the amount of the self-employment income for such taxable year.

(2) In the case of any taxable year beginning after December 31, 1953, and before January 1, 1960, the tax shall be equal to 3 per centum of the amount of the self-employment income for such taxable year.

(3) In the case of any taxable year beginning after December 31, 1959, and before January 1, 1965, the tax shall be equal to 3¾ per centum of the amount of the self-employment income for such taxable year.

(4) In the case of any taxable year beginning after December 31, 1964, and before January 1, 1970, the tax shall be equal to 4½ per centum of the amount of the self-employment income for such taxable year.

(5) In the case of any taxable year beginning after December 31, 1969, the tax shall be equal to 4⅞ per centum of the amount of the self-employment income for such taxable year.

[Sec. 480 as added by sec. 208 (a), Social Security Act Amendments 1950]

§ 39.480-1 *Tax on self-employment income.* (a) There is imposed, in addition to other taxes, a tax upon the self-employment income of every individual at the rates prescribed in section 480. This tax shall be levied, assessed, and collected as part of the income tax imposed by chapter 1 of the Internal Revenue Code and, except as otherwise expressly provided, will be included with the taxes imposed by sections 11 and 12 in computing any deficiency or overpayment and in computing the interest and additions to any deficiency, overpayment, or tax. Since the tax on self-employment income is part of the income tax, it is subject to the jurisdiction of The Tax Court of the United States to the same extent and in the same manner as the other taxes under chapter 1 of the Code. However, this tax is not required to be taken into account in computing any estimate of the taxes required to be declared under section 58.

(b) In general, self-employment income consists of the net earnings derived by an individual (other than a nonresident alien) from a trade or business carried on by him as sole proprietor or by a partnership of which he is a member, subject to certain exclusions, exceptions, and limitations.

§ 39.481 *Statutory provisions; net earnings from self-employment, self-employment income, and trade or business; definitions.*

SEC. 481. *Definitions.* For the purposes of this subchapter—

(a) *Net earnings from self-employment.* The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this chapter which are attributable to such trade or business, plus his distributive share (whether or not distributed) of the ordinary net income or loss, as computed under section 183, from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary net income or loss—

(1) There shall be excluded rentals from real estate (including personal property leased with the real estate) and deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer;

(2) There shall be excluded income derived from any trade or business in which, if the trade or business were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 1426 (h); and there shall be excluded all deductions attributable to such income;

(3) There shall be excluded dividends on any share of stock, and interest on any bond, debenture, note, or certificate or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof), unless such dividends and interest (other than interest described in section 25 (a)) are received in the course of a trade or business as a dealer in stocks or securities;

(4) There shall be excluded any gain or loss (A) which is considered as gain or loss from the sale or exchange of a capital asset, (B) from the cutting of timber, or the disposal of timber or coal, if section 117 (j) is applicable to such gain or loss, or (C) from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither (i) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor (ii) property held primarily for sale to customers in the ordinary course of the trade or business;

(5) The deduction for net operating losses provided in section 23 (s) shall not be allowed;

(6) (A) If any of the income derived from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income and deductions attributable to such trade or business shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife;

(B) If any portion of a partner's distributive share of the ordinary net income or loss from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner, and no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner;

(7) (A) In the case of any taxable year beginning before the effective date specified in section 3810, the term "possession of the United States" when used in section 251 with respect to citizens of the United States shall include Puerto Rico;

(B) In the case of any taxable year beginning on or after the effective date specified in section 3810, a resident of Puerto Rico shall compute his net earnings from self-employment in the same manner as a citizen of the United States but without regard to the provisions of section 116 (l).

If the taxable year of a partner is different from that of the partnership, the distributive share which he is required to include in computing his net earnings from self-employment shall be based upon the ordinary net income or loss of the partnership for any taxable year of the partnership (even though beginning prior to January 1, 1951) ending within or with his taxable year.

(b) *Self-employment income.* The term "self-employment income" means the net earnings from self-employment derived by an individual (other than a nonresident alien individual) during any taxable year beginning after December 31, 1950; except that such term shall not include—

(1) That part of the net earnings from self-employment which is in excess of: (A) $3,600, minus (B) the amount of the wages paid to such individual during the taxable year; or

(2) The net earnings from self-employment, if such net earnings for the taxable year are less than $400.

For the purposes of clause (1) the term "wages" includes such remuneration paid to an employee for services included under an agreement entered into pursuant to the provisions of section 218 of the Social Security Act (relating to coverage of State employees) as would be wages under section 1426 (a) if such services constituted employment under section 1426 (b). In the case of any taxable year beginning prior to the effective date specified in section 3810, an individual who is a citizen of Puerto Rico (but not otherwise a citizen of the United States) and who is not a resident of the United States or of the Virgin Islands during such taxable year shall be considered, for the purposes of this subchapter, as a nonresident alien individual. An individual who is not a citizen of the United States but who is a resident of the Virgin Islands or (after the effective date specified in section 3810) a resident of Puerto Rico shall not, for the purposes of this subchapter, be considered to be a nonresident alien individual.

(c) *Trade or business.* The term "trade or business," when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 23, except that such term shall not include—

(1) The performance of the functions of a public office;

(2) The performance of service by an individual as an employee (other than service described in section 1426 (b) (16) (B) performed by an individual who has attained the age of eighteen);

(3) The performance of service by an individual as an employee or employee representative as defined in section 1532;

(4) The performance of service by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order; or

(5) The performance of service by an individual in the exercise of his profession as a physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, or optometrist, Christian Science practitioner, architect, certified public accountant, accountant registered or licensed as an accountant, under State or municipal law, full-time practicing public accountant, funeral director or professional engineer; or the performance of such service by a partnership.

(d) *Employee and wages.* The term "employee" and the term "wages" shall have the same meaning as when used in subchapter A of chapter 9.

[Sec. 481 as added by sec. 208 (a), Social Security Act Amendments 1950; amended by sec. 221 (j) (1), Rev. Act 1950; sec. 325 (d), Rev. Act 1951]

§ 39.481-1 *Net earnings from self-employment*—(a) *Definition.* Subject to the special rules discussed in paragraph (c) of this section and to the exclusions discussed in § 39.481-3, the term "net earnings from self-employment" means—

(1) The gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by chapter 1 of the Internal Revenue Code which are attributable to such trade or business, plus

(2) His distributive share (whether or not distributed) of the ordinary net income (or minus the ordinary net loss) from any trade or business, as computed under section 183, carried on by any partnership of which he is a member.

(b) *Included in net earnings.* (1) The gross income and deductions of an individual attributable to a trade or business, for the purpose of ascertaining his net earnings from self-employment, are to be determined by reference to the provisions of law and regulations applicable with respect to the taxes imposed by sections 11 and 12. Thus, if an individual uses the accrual method of accounting in computing net income from a trade or business for the purpose of the taxes imposed by sections 11 and 12, he must use the same method in determining net earnings from self-

employment. Likewise, if a taxpayer engaged in a trade or business of selling property on the installment plan elects, under the provisions of section 44, to use the installment basis in computing income for the purpose of the taxes under sections 11 and 12, he must use the same basis in determining net earnings from self-employment.

(2) The trade or business must be carried on by the individual, either personally or through agents or employees. Accordingly, income derived from a trade or business carried on by an estate or trust is not included in determining the net earnings from self-employment of the individual beneficiaries of such estate or trust.

(3) Where an individual is engaged in more than one trade or business within the meaning of section 481 (c) and § 39.481–3, his net earnings from self-employment consist of the aggregate of the net income and losses (computed subject to the special rules provided in this section) of all such trades or businesses carried on by him. Thus, a loss sustained in one trade or business carried on by an individual will operate to offset the income derived by him from another trade or business.

(4) The net earnings from self-employment of an individual include, in addition to the earnings from a trade or business carried on by him, his distributive share of the ordinary net income or ordinary net loss from any trade or business carried on by each partnership of which he is a member. An individual's distributive share of the ordinary net income or ordinary net loss of a partnership shall be computed under section 183, subject to the special rules set forth in section 481 (a) and in this section and to the exclusions provided in section 481 (c) and in § 39.481–3.

(5) If the taxable year of a partner differs from that of the partnership, the partner shall include, in computing net earnings from self-employment, his distributive share of the ordinary net income or ordinary net loss of the partnership for its taxable year ending with or within the taxable year of the partner.

(6) For the purpose of determining net earnings from self-employment, a partnership is one which is recognized as such for income tax purposes. For income tax purposes, the term "partnership" includes not only a partnership as known at common law, but, also, a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any trade or business, financial operation, or venture, which is not, within the meaning of the Internal Revenue Code, a trust, estate, or a corporation.

(7) The net earnings from self-employment of a partner include his distributive share of the ordinary net income or ordinary net loss of the partnership of which he is a member, irrespective of the nature of his membership. Thus, in determining his net earnings from self-employment, a limited or inactive partner includes his distributive share of the ordinary net income or ordinary net loss of the partnership.

(c) *Excluded from net earnings.* For the purpose of computing net earnings from self-employment, the gross income derived by an individual from a trade or business carried on by him, the allowable deductions attributable to such trade or business, and the individual's distributive share of the ordinary net income or ordinary net loss from any trade or business carried on by a partnership of which he is a member shall be computed in accordance with the following special rules:

(1) *Rentals from real estate.* (i) Rentals from real estate (including personal property leased with the real estate) and the deductions attributable thereto, unless such rentals are received by an individual in the course of a trade or business as a real-estate dealer, are excluded. Whether or not an individual is engaged in the trade or business of a real-estate dealer is determined by the application of the principles followed in respect of the taxes imposed by sections 11 and 12. In general, an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is a real-estate dealer. On the other hand, an individual who merely holds real estate for investment or speculation and receives rentals therefrom is not considered a real-estate dealer. Where a real-estate dealer holds real estate for investment or speculation in addition to real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, only the rentals from the real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, and the deductions attributable thereto, are included in determining net earnings from self-employment; the rentals from the real estate held for investment or speculation, and the deductions attributable thereto, are excluded.

(ii) Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple-housing units are generally rentals from real estate. Except in the case of real-estate dealers, such payments are excluded in determining net earnings from self-employment even though such payments are in part attributable to personal property furnished under the lease.

(iii) Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, or for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rentals from real estate; consequently such payments are included in determining net earnings from self-employment. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas, the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, and so forth, are not considered as services rendered to the occupant.

(iv) Except in the case of a real-estate dealer, where an individual or a partnership is engaged in a trade or business the income of which is classifiable in part as rentals from real estate, only that portion of such income which is not classifiable as rentals from real estate, and the expenses attributable to such portion, will be included in determining net earnings from self-employment.

(v) The application of this subparagraph may be illustrated by the following example:

Example. A, an individual, owns a building containing four apartments. During the taxable year, he receives $1,400 from apartments numbered 1 and 2, which are rented without services rendered to the occupants, and $3,600 from apartments numbered 3 and 4, which are rented with services rendered to the occupants. His fixed expenses for the four apartments aggregate $1,200 during the taxable year. In addition, he has $500 of expenses attributable to the services rendered to the occupants of apartments 3 and 4. In determining his net earnings from self-employment, A includes the $3,600 received from apartments 3 and 4, and the expenses of $1,100 attributable thereto. The rentals and expenses attributable to apartments 1 and 2 are excluded. Therefore, A has $2,500 of net earnings from self-employment for the taxable year.

(2) *Income from agricultural activity.* (i) Income derived from any trade or business in which, if the trade or business were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 1426 (h), and all deductions attributable to such income, are excluded. In case the services are in part agricultural and in part nonagricultural, the time devoted to the performance of each type of service is the test to be used to determine whether the major portion of the services would constitute agricultural labor. If more than half of the time spent in performing all the services is spent in performing services which would constitute agricultural labor under section 1426 (h), all income, and the deductions attributable to the income, shall be excluded. If only half, or less, of the time spent in performing all the services is spent in performing services which would constitute agricultural labor under section 1426 (h), all income, and the deductions attributable to the income, shall be included. In every case the time spent in performing the services will be computed by adding the time spent in the trade or business during the taxable year by every individual (including the individual carrying on such trade or business and the members of his family) in performing such services. The operation of this special rule is not affected by section 1426 (c), relating to the included-excluded rule for determining employment.

(ii) This rule has no application where the nonagricultural services are

performed in connection with an enterprise which constitutes a trade or business separate and distinct from the trade or business conducted as an agricultural enterprise. Thus, the operation of a roadside automobile service station on farm premises constitutes a trade or business separate and distinct from the agricultural enterprise, and the gross income derived from such service station, together with the deductions attributable thereto, are included in determining net earnings from self-employment.

(3) *Dividends and interest.* (i) All dividends on shares of stock are excluded unless they are received by an individual in the course of his trade or business as a dealer in stocks or securities.

(ii) Interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof), is excluded unless such interest is received in the course of a trade or business as a dealer in stocks or securities. However, interest which is exempt under section 25 (a) from the normal tax imposed by section 11, that is, interest on certain obligations of the United States and its instrumentalities, is not included in net earnings from self-employment even though received in the course of a trade or business as a dealer in stocks or securities. Only interest on bonds, debentures, notes, or certificates, or other evidence of indebtedness, issued with interest coupons or in registered form by a corporation, is excluded in the case of all persons other than dealers in stocks or securities; other interest received in the course of any trade or business (such as interest received by a pawnbroker on his loans or interest received by a merchant on his accounts or notes receivable) is not excluded.

(iii) Dividends and interest of the character excludible under the preceding subdivisions of this subparagraph received by an individual on stocks or securities held for speculation or investment are excluded whether or not the individual is a dealer in stocks or securities.

(iv) A dealer in stocks or securities is a merchant of stocks or securities with an established place of business, regularly engaged in the business of purchasing stocks or securities and reselling them to customers; that is, he is one who as a merchant buys stocks or securities and sells them to customers with a view to the gains and profits that may be derived therefrom. Persons who buy and sell or hold stocks or securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, are not dealers in stocks or securities.

(4) *Gain or loss from disposition of property.* (i) There is excluded any gain or loss: (*a*) Which is considered as gain or loss from the sale or exchange of a capital asset; (*b*) from the cutting of timber or the disposal of timber or the disposal of coal, even though held primarily for sale to customers, if section 117 (j) is applicable to such gain or loss; and (*c*) from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither (*1*) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor (*2*) property held primarily for sale to customers in the ordinary course of a trade or business. For the purpose of the special rule in (*c*) of this subdivision, it is immaterial whether a gain or loss is treated as a capital gain or loss or as an ordinary gain or loss for purposes other than determining net earnings from self-employment. For instance, where the character of a loss is governed by the provisions of section 117 (j), such loss is excluded in determining net earnings from self-employment even though such loss is treated under section 117 (j) as an ordinary loss. For the purposes of this special rule, the term "involuntary conversion" means a compulsory or involuntary conversion of property into other property or money 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; and, the term "other disposition" includes the destruction or loss, in whole or in part, of property by fire, storm, shipwreck, or other casualty, or by theft, even though there is no conversion of such property into other property or money.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. During the taxable year 1952, A, who owns a grocery store, realized a net profit of $1,500 from the sale of groceries and a gain of $350 from the sale of a refrigerator case. During the same year, he sustained a loss of $2,000 as a result of damage by fire to the store building. In computing net income, all of these items are taken into account. In determining net earnings from self-employment, however, only the $1,500 of profit derived from the sale of groceries is included. The $350 gain and the $2,000 loss are excluded.

(5) *Net operating loss deduction.* The deduction provided by section 23 (s), relating to net operating losses sustained in years other than the taxable year, is excluded.

(6) *Community income*—(i) *In case of an individual.* If any of the income derived by an individual from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income, and the deductions attributable to such income, shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife. For the purpose of this special rule, the term "management and control" means management and control in fact, not the management and control imputed to the husband under the community property laws. For example, a wife who operates a beauty parlor without any appreciable collaboration on the part of her husband will be considered as having substantially all of the management and control of such business despite the provision of any community property law vesting in the husband the right of management and control of community property; and the income and deductions attributable to the operation of such beauty parlor will be considered the income and deductions of the wife.

(ii) *In case of a partnership.* Even though a portion of a partner's distributive share of the ordinary net income or ordinary net loss from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner; no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner. In any case in which both spouses are members of the same partnership, the distributive share of the ordinary net income or ordinary net loss of each spouse is included in computing the net earnings from self-employment of that spouse.

(7) *Puerto Rico*—(i) *Residents.* A resident of Puerto Rico, whether or not a bona fide resident thereof during the entire taxable year, and whether or not an alien, a citizen of the United States, or a citizen of Puerto Rico, shall compute his net earnings from self-employment in the same manner as would a citizen of the United States residing in the United States. For the purpose of the tax on self-employment income, the gross income of such a resident of Puerto Rico also includes income from Puerto Rican sources. Thus, under this special rule, income from Puerto Rican sources will be included in determining net earnings from self-employment of a resident of Puerto Rico engaged in the active conduct of a trade or business in Puerto Rico despite the fact that, under section 116 (l), such income may not be taken into account for the purpose of the taxes under sections 11 and 12.

(ii) *Nonresidents.* A citizen of Puerto Rico who is also a citizen of the United States and who is not a resident of Puerto Rico will compute his net earnings from self-employment in the same manner and subject to the same provisions of law and regulations as other citizens of the United States.

§ 39.481-2 *Self-employment income*—(a) *In general.* Except for the exclusions in paragraphs (b) and (c) and the exception in paragraph (d) of this section, the term "self-employment income" means the net earnings from self-employment derived by an individual.

(b) *Maximum self-employment income.* The maximum self-employment income of an individual for any taxable year (whether a period of 12 months or less) is $3,600. If an individual is paid wages as defined in section 1426 (a), the maximum is the excess of $3,600 over the amount of such wages. For example, if during the taxable year no such wages

are paid and the individual has $5,000 of net earnings from self-employment, he has $3,600 of self-employment income for such taxable year. If, in addition to having $5,000 of net earnings from self-employment, such individual is paid $1,000 of such wages, he has only $2,600 of self-employment income for the taxable year. For the purpose of this limitation, the term "wages" includes remuneration paid to an employee for services covered by an agreement entered into pursuant to section 218 of the Social Security Act (42 U. S. C. 418) which section provides for extension of the Federal old-age and survivors insurance system to State and local government employees under voluntary agreements between the States and the Secretary of Health, Education, and Welfare (Federal Security Administrator before April 11, 1953)

(c) *Minimum net earnings from self-employment.* Self-employment income does not include the net earnings from self-employment of an individual when the amount of such earnings for the taxable year is less than $400. Thus, an individual having only $300 of net earnings from self-employment for the taxable year would not have any self-employment income. However, an individual having net earnings from self-employment of $400 or more for the taxable year may have less than $400 of self-employment income. This would occur in a case in which the amount of the individual's net earnings from self-employment is $400 or more for a taxable year and the individual also receives more than $3,200 but less than $3,600 of wages during that taxable year. For example, if an individual has net earnings from self-employment of $1,000 for a taxable year and also receives wages of $3,400 during that taxable year, his self-employment income for that taxable year is $200.

(d) *Nonresident aliens.* A nonresident alien individual never has self-employment income. For the purpose of the tax on self-employment income, an individual who is not a citizen of the United States but who is a resident of the Virgin Islands or of Puerto Rico is not considered to be a nonresident alien individual. While a nonresident alien individual who derives income from a trade or business carried on within the United States, Puerto Rico, or the Virgin Islands (whether by agents or employees, or by a partnership of which he is a member) may be subject to the applicable income tax provisions on such income, such nonresident alien individual will not be subject to the tax on self-employment income, since any net earnings which he may have from self-employment do not constitute self-employment income.

§ 39.481–3 *Trade or business*—(a) *In general.* It is necessary for an individual to carry on a trade or business, either as an individual or as a member of a partnership, in order for him to have net earnings from self-employment. Except for the exclusions discussed in paragraphs (b) (c) (d) (e) and (f) of this section, the term "trade or business" for the purpose of the tax on self-employment income, shall have the same meaning as when used in section 23. An individual engaged in one of the excluded activities specified in this section may also be engaged in carrying on a non-excluded trade or business. Whether or not he is also engaged in an included trade or business will be dependent upon all of the facts and circumstances in the particular case.

(b) *Public office.* The performance of the functions of a public office does not constitute a trade or business. The term "public office" includes any elective or appointive office of the United States or any possession thereof, or of a State or its political subdivision, or of a wholly owned instrumentality of any one or more of the foregoing. For example, the President, the Vice President, a governor, a mayor, the Secretary of State, a member of Congress, a State representative, a county commissioner, a judge, a county or city attorney a marshal, a sheriff, a register of deeds, or a notary public performs the functions of a public office.

(c) *Employees.* The performance of service by an individual as an employee, as defined in the Federal Insurance Contributions Act (sections 1400 to 1432 inclusive, of the Internal Revenue Code), with one exception, does not constitute a trade or business. The exception is as follows: Service performed by an individual, who has attained the age of 18, in, and at the time of, the sale of newspapers or magazines to ultimate consumers, under an arrangement under which the newspapers or magazines are to be sold by him at a fixed price, his compensation being based on the retention of the excess of such price over the amount at which the newspapers or magazines are charged to him, whether or not he is guaranteed a minimum amount of compensation for such service, or is entitled to be credited with the unsold newspapers or magazines turned back, does constitute a trade or business. As to when an individual is an employee, see Regulations 128 (Part 408 of this chapter) relating to the Federal Insurance Contributions Act.

(d) *Individuals under Railroad Retirement System.* The performance of service by an individual as an employee or employee representative as defined in section 1532, that is, an individual covered under the railroad retirement system, does not constitute a trade or business. As to when an individual is an employee or employee representative under section 1532, see Regulations 114 (Part 411 of this chapter) relating to the Railroad Retirement Tax Act.

(e) *Ministers or members of religious orders.* The performance of service by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order does not constitute a trade or business. The duties of ministers include the ministration of sacerdotal functions and the conduct of religious worship, and the control, conduct, and maintenance of religious organizations (including the religious boards, societies, and other integral agencies of such organizations), under the authority of a religious body constituting a church or church denomination.

(f) *Members of certain professions.* (1) The performance of service by an individual in the exercise of his profession as a physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, optometrist, Christian Science practitioner, architect, certified public accountant, accountant registered or licensed as an accountant under State or municipal law, full-time practicing public accountant, funeral director, or professional engineer does not constitute a trade or business. This exclusion applies only if the individual meets the legal requirements, if any, for practicing his profession in the place where he performs the service. Thus, an accountant who is neither certified, registered, nor licensed but who is publicly engaged in the practice of accountancy on a full-time basis in a jurisdiction which requires that an individual engaged in such practice be certified, registered, or licensed is not within the exclusion.

(2) The designations in subparagraph (1) of this paragraph are to be given their commonly accepted meaning. Thus, the term "physician" means an individual who is legally qualified to practice medicine; the term "lawyer" means an individual who is legally qualified to practice law and the term "professional engineer" means an engineer legally qualified to practice before the public in a consulting capacity.

(3) In the case of a partnership engaged in the practice of any of the designated professions, the partnership shall not be considered as carrying on a trade or business for the purpose of the tax on self-employment income, and none of the distributive shares of the ordinary net income or the ordinary net loss of such partnership shall be included in computing net earnings from self-employment of any member of the partnership. On the other hand, where a partnership is engaged in a trade or business not within any of the designated professions, each partner must include his distributive share of the ordinary net income or the ordinary net loss of such partnership in computing his net earnings from self-employment, irrespective of whether such partner is also engaged in the practice of one or more of such professions and contributes his professional services to the partnership.

§ 39.481–4 *Employee and wages.* For the purpose of the tax on self-employment income, the term "employee" and the term "wages" shall have the same meaning as when used in the Federal Insurance Contributions Act. For an explanation of these terms, see Regulations 128 (Part 408 of this chapter)

§ 39.482 *Statutory provisions; returns for tax on self-employment income; cross references.*

SEC. 482. *Miscellaneous provisions*—(a) *Returns.* Every individual (other than a nonresident alien individual) having net earnings from self-employment of $400 or more for the taxable year shall make a return containing such information for the

purpose of carrying out the provisions of this subchapter as the Commissioner, with the approval of the Secretary, may by regulations prescribe. Such return shall be considered a return required under section 51 (a). In the case of a husband and wife filing a joint return under section 51 (b), the tax imposed by this subchapter shall not be computed on the aggregate income but shall be the sum of the taxes computed under this subchapter on the separate self-employment income of each spouse.

(b) *Title of subchapter.* This subchapter may be cited as the "Self-Employment Contributions Act."

(c) *Effective date in case of Puerto Rico.* For effective date in case of Puerto Rico, see section 3810.

(d) *Collection of taxes in Virgin Islands and Puerto Rico.* For provisions relating to collection of taxes in Virgin Islands and Puerto Rico, *see section 3811.*

[Sec. 482 as added by sec. 208 (a), Social Security Act Amendments 1950]

§ 39.482-1 *Returns*—(a) *In general.* Every individual, other than a nonresident alien, having net earnings from self-employment of $400 or more for the taxable year shall make a return on Form 1040 in accordance with the instructions thereon, or issued therewith, and the provisions of the regulations applicable thereto. Such return shall be considered a return required under section 51 (a), and the provisions applicable to returns under section 51 (a) shall be applicable to this return. This return will be required if there is self-employment income even though the individual may not be required to make a return for the purpose of the taxes imposed by sections 11 and 12.

(b) *Joint returns.* (1) In the case of a husband and wife filing a joint return under section 51 (b) the tax on self-employment income is computed on the separate self-employment income of each spouse, and not on the aggregate of the two amounts. The requirement of section 51 (b) that in the case of a joint return the tax is computed on the aggregate income of the spouses is not applicable with respect to the tax on self-employment income. Where the husband and wife each has net earnings from self-employment of $400 or more, it will be necessary for each to complete separately a schedule C of Form 1040 with respect to such net earnings, despite the fact that a joint return is filed. If the net earnings from self-employment of either the husband or the wife are less than $400, such net earnings are not subject to the tax on self-employment income, even though they must be shown on the joint return for the purpose of the taxes imposed by sections 11 and 12.

(2) Except as otherwise expressly provided, section 51 (b) is applicable to the return of the tax on self-employment income; therefore, the liability with respect to such tax in the case of a joint return is joint and several.

(c) *Social security account numbers.* Every individual making a return of net earnings from self-employment is required to show thereon his social security account number, or, if he has no such account number, to make application therefor on Form SS-5 before the filing of such return. However, the failure to apply for a social security account number will not excuse the individual from the requirement that he file such return on or before the due date thereof. Form SS-5 may be obtained from any field office of the Social Security Administration or from any district director of internal revenue. The application on Form SS-5 shall be filed with the field office of the Social Security Administration nearest the legal residence or principal place of business of such individual, or if he has no legal residence or principal place of business within the United States; Puerto Rico, or the Virgin Islands, with the office of the Social Security Administration at Baltimore, Maryland. An individual who has previously secured a social security account number as an employee shall use that account number on his return of net earnings from self-employment.

SUBPART E—PERSONAL HOLDING COMPANIES (SUBCHAPTER A, CHAPTER 2, INTERNAL REVENUE CODE)

§ 39.500 *Statutory provisions; surtax on personal holding companies.*

SEC. 500. *Surtax on personal holding companies.* There shall be levied, collected, and paid, for each taxable year beginning after December 31, 1938, upon the undistributed subchapter A net income of every personal holding company (in addition to the taxes imposed by chapter 1) a surtax equal to the sum of the following:

(1) 75 per centum of the amount thereof not in excess of $2,000; plus

(2) 85 per centum of the amount thereof in excess of $2,000.

[Sec. 500 as amended by sec. 203, Rev. Act 1940; sec. 110 (a), Rev. Act 1941; sec. 181, Rev. Act 1942]

§ 39.500-1 *Surtax on personal holding companies.* (a) Section 500 imposes (in addition to the taxes imposed by chapter 1) a graduated income tax or surtax upon corporations classified as personal holding companies and, under the circumstances specified in section 501 (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 chapter 1. Unlike the surtax imposed by section 102, the surtax imposed by section 500 applies to all personal holding companies defined as such in section 501 and § 39.501-1, 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 500 is 75 percent of the amount of the undistributed subchapter A net income not in excess of $2,000, and 85 percent of the amount of the undistributed subchapter A net income in excess of $2,000. For the alternative tax where the net long-term gain for any taxable year exceeds the net short-term capital loss, see section 117 (c) and the regulations thereunder.

(b) A foreign corporation, whether resident or nonresident, which is classified as a personal holding company under section 501 (not including a foreign personal holding company as defined in section 331) is subject to the tax imposed by section 500 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 subchapter A of chapter 2, 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.

§ 39.501 *Statutory provisions; definition of personal holding company.*

SEC. 501. *Definition of personal holding company*—(a) *General rule.* For the purposes of this subchapter and chapter 1, 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 502; 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—

(1) A corporation exempt from taxation under section 101.

(2) A bank as defined in section 104.

(3) A life insurance company.

(4) A surety company.

(5) A foreign personal holding company as defined in section 331.

(6) (A) A licensed personal finance company under State supervision, 80 per centum or more of the gross income of which is lawful interest received from loans made to individuals in accordance with the provisions of applicable State law if at least 60 per centum of such gross income is lawful interest (i) received from individuals each of whose indebtedness to such company did not at any time during the taxable year exceed in principal amount the limit prescribed for small loans by such law (or, if there is no such limit, $300), and (ii) not payable in advance or compounded and computed only on unpaid balances, and if the loans to a person, who is a shareholder in such company during the taxable year by or for whom 10 per centum or more in value of its outstanding stock is owned directly or indirectly (including in the case of an individual, stock owned by the members of his family as defined in section 503 (a) (2)), outstanding at any time during such year do not exceed $5,000 in principal amount; and

(B) A lending company, not otherwise excepted by section 501 (b), authorized to engage in the small loan business under one

or more State statutes providing for the direct regulation of such business, 80 per centum or more of the gross income of which is lawful interest, discount or other authorized charges (i) received from loans maturing in not more than thirty-six months made to individuals in accordance with the provisions of applicable State law, and (ii) which do not, in the case of any individual loan, exceed in the aggregate an amount equal to simple interest at the rate of 3 per centum per month not payable in advance and computed only on unpaid balances, if at least 60 per centum of the gross income is lawful interest, discount or other authorized charges received from individuals each of whose indebtedness to such company did not at any time during the taxable year exceed in principal amount the limit prescribed for small loans by such law (or, if there is no such limit, $500), and if the deductions allowed to such company under section 23 (a) (relating to expenses), other than for compensation for personal services rendered by shareholders (including members of the shareholder's family as described in section 503 (a) (2)) constitute 15 per centum or more of its gross income, and the loans to a person, who is a shareholder in such company during the taxable year by or for whom 10 per centum or more in value of its outstanding stock is owned directly or indirectly (including in the case of an individual, stock owned by the members of his family as defined in section 503 (a) (2)), outstanding at any time during such year do not exceed $5,000 in principal amount.

(7) A loan or investment corporation, a substantial part of the business of which consists of receiving funds not subject to check and evidenced by installment or fully paid certificates of indebtedness or investment, and making loans and discounts, and the loans to a person who is a shareholder in such corporation during such taxable year by or for whom 10 per centum or more in value of its outstanding stock is owned directly or indirectly (including in the case of an individual, stock owned by the members of his family as defined in section 503 (a) (2)) outstanding at any time during such year do not exceed $5,000 in principal amount.

(8) A finance company, actively and regularly engaged in the business of purchasing or discounting accounts or notes receivable or installment obligations, or making loans secured by any of the foregoing or by tangible personal property, at least 80 per centum of the gross income of which is derived from such business in accordance with the provisions of applicable State law or does not constitute personal holding company income as defined in section 502, if 60 per centum of the gross income is derived from one or more of the following classes of transactions:

(A) Purchasing or discounting accounts or notes receivable, or installment obligations evidenced or secured by contracts of conditional sale, chattel mortgages, or chattel lease agreements, arising out of the sale of goods or services in the course of the transferor's trade or business;

(B) Making loans, maturing in not more than thirty-six months, to, and for the business purposes of, persons engaged in trade or business, secured by—

(i) Accounts or notes receivable, or installment obligations, described in subparagraph (a) above;

(ii) Warehouse receipts, bills of lading, trust receipts, chattel mortgages, bailments, or factor's liens, covering or evidencing the borrower's inventories;

(iii) A chattel mortgage on property used in the borrower's trade or business;

except loans to any single borrower which for more than ninety days in the taxable year of the company exceed 15 per centum of the average funds employed by the company during such taxable year;

(C) Making loans, in accordance with the provisions of applicable State law, secured by chattel mortgages on tangible personal property, the original amount of each of which is not less than the limit referred to in, or prescribed by, subsection (b) (6) (A) (i), and the aggregate principal amount of which owing by any one borrower to the company at any time during the taxable year of the company does not exceed $5,000; and

(D) If 30 per centum or more of the gross income of the company is derived from one or more of the classes of transactions described in subparagraphs (A), (B) and (C) of this paragraph, purchasing, discounting, or lending upon the security of, installment obligations of individuals where the transferor or borrower acquired such obligations either in transactions of the classes described in subparagraphs (A) and (C) of this paragraph or as a result of loans made by such transferor or borrower in accordance with the provisions of clauses (i) and (ii) of paragraph 6 (A) or of clauses (i) and (ii) of paragraph 6 (B) of this subsection, if the funds so supplied at all times bear an agreed ratio to the unpaid balance of the assigned installment obligations; and documents evidencing such obligations are held by the company;

provided that the deductions allowable under subsection 23 (a) (relating to expenses), other than compensation for personal services rendered by shareholders (including members of the shareholder's family as described in section 503 (a) (2)), constitute 15 per centum or more of the gross income, and that loans to a person who is a shareholder in such company during such taxable year by or for whom 10 per centum or more in value of its outstanding stock is owned directly or indirectly (including in the case of an individual, stock owned by members of his family as defined in section 503 (a) (2)) outstanding at any time during such year do not exceed $5,000 in principal amount.

(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 501 (a) (2), and the income of such affiliated group, determined as provided in section 141, satisfies the gross income requirement provided in section 501 (a) (1), such affiliated group shall be subject to the surtax imposed by this subchapter. The preceding sentence shall apply only if the common parent corporation is a common parent of an affiliated group of railroad corporations, which would be eligible to file consolidated returns under section 141 prior to its amendment by the Revenue Act of 1942.

[Sec. 501 as amended by secs. 182 (a), 183, Rev. Act 1942; Public Law 680 (81st Cong.)]

§ 39.501–1 *Definition of personal holding company.* (a) A personal holding company is any corporation (other than a corporation specified in section 501 (b)) which for the taxable year meets (1) the gross income requirement specified in § 39.501–2, and (2) the stock ownership requirement specified in § 39.501–3. Both requirements must be satisfied and both must be met with respect to each taxable year.

(b) Section 501 (b) provides that the term "personal holding company" does not include: (1) Corporations exempt from taxation under section 101, (2) a bank as defined in section 104, (3) a life insurance company, (4) a surety company, (5) a foreign personal holding company as defined in section 331, (6) a loan or investment corporation as defined in section 501 (b) (7), (7) a licensed personal finance company as defined in section 501 (b) (6) (A), (8) a lending company as defined in section 501 (b) (6) (B) or (9) a finance company (whether or not previously classified as a personal holding company) as defined in section 501 (b) (8)

§ 39.501–2 *Gross income requirement.* (a) 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 502:

(1) 80 percent or more; or

(2) 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—

(i) 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 501 (a) (2) exists; or

(ii) 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.

(b) 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 thereunder.

§ 39.501–3 *Stock ownership requirement.* (a) 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 503 and the regulations thereunder.

(b) 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.

(c) 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 re-

flected 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.

(d) The rules stated in paragraphs (b) and (c) of this section are equally applicable in determining the stock ownership requirement specified in section 502 (e) relating to personal service contracts, and in section 502 (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.

§ 39.502 *Statutory provisions; personal holding company income; definition.*

SEC. 502. *Personal holding company income.* For the purposes of this subchapter 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.* Amounts includible in computing the net income of the corporation under Supplement E of chapter 1; 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 shareholders.* 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.

§ 39.502-1 *Personal holding company income.* The term "personal holding company income" means the portion of the gross income which consists of the following:

(a) *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). See § 39.115 (a)-1.

(b) *Interest (other than interest constituting rent).* The term "interest" means any amounts, includible in gross income, received for the use of money loaned except that it does not include interest constituting rent (see paragraph (j) of this section).

(c) *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.

(d) *Annuities.* The term "annuities" includes annuities only to the extent includible in the computation of gross income. (See section 22 (b) (2).)

(e) *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 502 (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 502 (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 Internal Revenue Code) 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.

(f) *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.

(g) *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, inclusive, together with the gains derived by the corporation from the sale or other disposition of any interest in an estate or trust.

(h) *Amounts received under personal service contracts.* (1) 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—

(i) 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

(ii) 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 pro-

vided in section 503 and the regulations thereunder and § 39.501-3 (d)

(2) The application of section 502 (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. 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.

(i) *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 503 and the regulations thereunder and § 39.501-3 (d)

(j) *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 502 (f) and paragraph (i) of this section. However, rents do not constitute personal holding company income if constituting 50 percent or more of the gross income of the corporation.

(k) *Mineral, oil, or gas royalties.* (1) The income from mineral, oil, or gas royalties is to be included as personal holding company income, unless the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year and 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.

(2) 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 minerals specified in § 39.23 (m)-1 (d) As used in this subparagraph 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.

§ 39.503 (a) *Statutory provisions; constructive stock ownership.*

SEC. 503. *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 501 (a) (2), section 502 (e), or section 502 (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 501 (a) (2), if, but only if, the effect is to make the corporation a personal holding company;

(B) For the purposes of section 502 (e) (relating to personal service contracts), or of section 502 (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).

§ 39.503 (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 501 (a) (2) and § 39.501-3, 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 502 (e) and paragraph (h) of § 39.502-1, 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 502 (f) and paragraph (i) of § 39.502-1,

stock owned by an individual includes stock constructively owned by him as provided in section 503. For such purpose constructive ownership of stock shall be determined and applied in accordance with the rules provided in section 503 and the regulations thereunder. All forms and classes of stock, however denominated, which represents the interests of shareholders, members, or beneficiaries in the corporation shall be taken into consideration.

§ 39.503 (a)-2 *Stock not owned by individual.* In determining the ownership of stock for any of the purposes set forth in § 39.503 (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 § 39.503 (a)-6.

§ 39.503 (a)-3 *Family and partnership ownership.* (a) In determining the ownership of stock for any of the purposes set forth in § 39.503 (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.

(b) The application of the family and partnership rule in determining the ownership of stock for the purpose set forth in § 39.503 (a)-1 (a) 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	100	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 503 (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.

(c) 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 § 39.503 (a)-1 (b)

§ 39.503 (a)-4 *Options.* In determining the ownership of stock for any of the purposes set forth in § 39.503 (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 section 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.

§ 39.503 (a)-5 *Application of family-partnership and option rules.* The family and partnership rule provided in section 503 (a) (2) and § 39.503 (a)-3 and the option rule provided in section 503 (a) (3) and § 39.503 (a)-4 shall be applied—

(a) For the purpose stated in § 39.503 (a)-1 (a) 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 § 39.503 (a)-1 (b) 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 § 39.503 (a)-1 (c) if, but only if, the effect of such application is to make the compensation for the use of the 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 § 39.503 (a)-1.

§ 39.503 (a)-6 *Constructive ownership as actual ownership.* (a) In determining the ownership of stock for any of the purposes set forth in § 39.503 (a)-1—

(1) Stock constructively owned by a person by reason of the application of the rule provided in section 503 (a) (1), relating to stock not owned by an individual (see § 39.503 (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 503 (a) (2) (see § 39.503 (a)-3) in order to make another person the constructive owner of such stock, and

(2) Stock constructively owned by a person by reason of the application of the option rule provided in section 503 (a) (3) (see § 39.503 (a)-4) shall be considered as actually owned by such person for the purpose of applying either the rule provided in section 503 (a) (1) relating to stock not owned by an individual, or the family and partnership rule provided in section 503 (a) (2) in order to make another person the constructive owner of such stock, but

(3) Stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 503 (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.

(b) The application of this section may be illustrated by the following examples:

Example (1). A's wife, AW, owns all 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 503 (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 503 (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 §39.503 (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 503 (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 503 (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 503 (a) (1) likewise is considered as actual ownership for the purpose, if necessary, of applying the family and partnership rule provided in section 503 (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.

§ 39.503 (a)-7 *Option rule in lieu of family and partnership rule.* (a) If, in determining the ownership of stock for any of the purposes set forth in § 39.503 (a)-1, stock may be considered as constructively owned by an individual by an application of both the family-partnership rule provided in section 503 (a) (2) (see § 39.503 (a)-3) and the option rule provided in section 503 (a) (3) (see § 39.503 (a)-4) such stock shall be considered as owned constructively by the individual by reason of the application of the option rule.

(b) The application of this section 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 section 39.503 (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 § 39.503 (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 § 39.503 (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 503 (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.

§ 39.503 (b) *Statutory provision, owning of convertible securities treated as stock ownership.*

SEC. 503. *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 501 (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 502 (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 502 (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.

§ 39.503 (b)-1 *Convertible securities.* Under section 503 (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 501 (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 502 (e) relating to amounts received under personal service contracts, or of section 502 (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 1952, 1953, and 1954, those convertible in 1952 can be properly considered as outstanding stock without so considering those convertible in 1953 or 1954, and those convertible in 1952 and 1953 can be properly considered as outstanding stock without so considering those convertible in 1954. However, the securities convertible in 1953 could not be properly considered as outstanding stock without so considering those convertible in 1952 and the securities convertible in 1954 could not be properly considered as outstanding stock without so considering those convertible in 1952 and 1953.

§ 39.504 *Statutory provisions; undistributed subchapter A net income; definition.*

SEC. 504. *Undistributed subchapter A net income.* For the purposes of this subchapter the term "undistributed subchapter A net income" means the subchapter A net income (as defined in section 505) 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 subchapter, the amount allowed under subsection (c) of this section or of section 405 of the Revenue Act of 1938 in the computation of the tax under this subchapter or under Title IA of the Revenue Act of 1938 for any preceding taxable year beginning after December 31, 1937, 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 would have been includible in the computation of the basic surtax credit for the taxable year if distributed during such taxable year; but the amount allowed under this subsection shall not exceed either:

(1) The undistributed Subchapter A net income for the taxable year computed without regard to this subsection; or

(2) 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 subchapter for the taxable year preceding the taxable year or, in the case of a taxable year beginning in 1939, * * *); and

(B) The consent dividends credit for the taxable year.

(d) * * * [not applicable].

(e) The amount by which the undistributed subchapter A net income determined without reference to this subsection exceeds the amount which could be distributed on the last day of the taxable year as a dividend (1) without violating any action, regulation, rule, order, or proclamation taken, promulgated, made, or issued by, or pursuant to the direction of, the President or any agency that he may designate, under the Trading With the Enemy Act of October 16, 1917, as amended, or the First War Powers Act of 1941, and (2) not subject to a lien in favor of the United States.

[Sec. 504 as amended by sec. 228 (a), Rev. Act 1939; Pub. Law 18 (77th Cong.); secs. 132 (d), 184 (a), 186 (c), Rev. Act 1942; sec. 349, Rev. Act 1951]

§ 39.504-1 *Undistributed subchapter A net income.* The term "undistributed subchapter A net income" means the subchapter A net income (as defined in section 505 and § 39.505-1) minus (a) the amount of the dividends paid credit provided in section 27 (a) (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 § 39.504-2), and (c) dividends paid after the close of the taxable year and before the 15th day of the third month thereafter, if claimed under section 504 (c) in the return, but only to the extent and subject to the limitations contained in that section. In computing the dividends paid credit for the purposes of subchapter A of chapter 2, the amount allowed under section 504 (c) in the computation of the tax under subchapter A for any preceding taxable year is considered a dividend paid in such preceding taxable year and not in the year of distribution.

§ 39.504-2 *Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934*—(a) *Indebtedness.* (1) 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.

(2) The indebtedness must have been incurred (or, if incurred by assumption, assumed) by the taxpayer before 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 refunding, renewal, or other change in the form of an indebtedness, 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. In the case of refunding, renewal, or other change in the form of an indebtedness, 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 are not permitted.

(c) *Reasonableness of the amounts with reference to the size and terms of the indebtedness.* (1) 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.

(2) 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.

(3) 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 before 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.

§ 39.505 *Statutory provisions; subchapter A net income; definition for the purpose of this subchapter.*

SEC. 505. *Subchapter A net income.* For the purposes of this subchapter the term "Subchapter A 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 500, 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. For the purposes of the preceding sentence, payment of any contribution or gift shall be considered as made within the taxable year if and only if it is considered for the purposes of section 23 (q) as made within such year. For disallowance of certain charitable, etc., deductions otherwise allowable under this paragraph, see sections 3813 and 162 (g) (2).

(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.

(c) *Net loss carry-over disallowed.* The deduction for net operating losses provided in section 23 (s) shall not be allowed.

(d) *1941 capital loss carry-over denied.*

* * *

(e) *Income not placed on annual basis.* The net income shall be computed without regard to section 47 (c).

[Sec. 505 as amended by secs. 211 (l), 212 (d), Rev. Act 1939; secs. 135 (b) (4), 150 (l), Rev. Act 1942; sec. 3 (b), Pub. Law 378 (81st Cong.); sec. 332 (d), Rev. Act 1950]

SEC. 11. *Denial of tax deductions and exemptions* [*Internal Security Act of 1950*]. (a) Notwithstanding any other provision of law, no deduction for Federal income-tax purposes shall be allowed in the case of a contribution to or for the use of any organization if at the time of the making of such contribution (1) such organization is registered under section 7, or (2) there is in effect a final order of the Board [the Subversive Activities Control Board] requiring such organization to register under section 7.

* * * * *

§ 39.505-1 *Subchapter A net income.* (a) The term "subchapter A 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 505. In the case of a foreign corporation, whether resident or nonresident, which files or causes a return to be filed, the "subchapter A 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 505. In the case of a foreign corporation, whether resident or nonresident, which files no return the "subchapter A 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 505 (a) but without the benefit of any deductions under chapter 1 (see section 233). In the case of a taxable year of less than 12 months on account of a change in the accounting period of the corporation, the subchapter A net income is computed on the basis of the period included in the taxable year, and is not placed on an annual basis under section 47 (c)

(b) The "subchapter A 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 "subchapter A 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.

(c) The foreign tax credit permitted by section 131 with respect to the taxes imposed by chapter 1 is not allowed with respect to the surtax imposed by section 500. 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 chapter 1 a credit for such taxes is taken.

(d) In addition to the qualifications, limitations, and exceptions provided in section 505 (a), a personal holding company is subject to the provisions of section 505 (b) and (c) in the computation of its subchapter A net income. Section 505 (c) provides that the net operating loss deduction provided by section 23 (s) shall not be allowed. Under section 505 (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.

(e) The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If, in computing its subchapter A 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:

(1) A description of the property;

(2) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(3) The name and address of the person from whom acquired and the date thereof;

(4) 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;

(5) 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;

(6) Evidence that the rent or other compensation was the highest obtainable and, if none was received, a statement of the reasons therefor;

(7) A copy of the contract, lease or rental agreement;

(8) The purpose for which the property was used;

(9) 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;

(10) 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

(11) Any other information pertinent to the taxpayer's claim.

§ 39.505-2 *Illustration of computation of subchapter A net income, undistributed subchapter A net income, and surtax.* The method of computation of the subchapter A net income, the undistributed subchapter A net income, and the surtax under subchapter A of chapter 2 may be illustrated as follows:

(a) 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 1952:

(1) The net income, as computed under chapter 1, amounts to $200,000.

(2) Federal income tax imposed by sections 13 and 15 (after certain credits under section 26) amounted to $73,300 and was paid in installments—$25,655 on March 15, 1952; $25,655 on June 15, 1952; $10,995 on September 15, 1952; $10,995 on December 15, 1952.

(3) 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 $36,000, of which $10,000 is deducted in arriving at the net income under chapter 1.

(4) 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 505 (b) and § 39.505-1.

(5) Dividends paid by the corporation to its shareholders during the taxable year which are allowable as a credit under section 27 (a) amount to $80,000.

(6) The amount used during the year to pay indebtedness incurred by the corporation before January 1, 1934, is $31,250.

(7) On March 1, 1953, the corporation paid its shareholders a taxable dividend of $15,000 and in its return, on Form 1120H, claimed a deduction under section 504 (c) of $8,000, that being 10 percent of the dividends paid during the taxable year 1952.

(b) The subchapter A net income, the undistributed subchapter A net income, and the surtax are computed as follows:

Net income under ch. 1		$200,000
Add:		
Contributions deductible in computing net income under sec. 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 sec. 505 (b)		235,000
Less:		
Federal income tax	$73,300	
Contributions deductible under sec. 505 (a) (2) (15 percent of $235,000)	35,250	
		108,550
Subchapter A net income		126,450
Less:		
Dividends paid credit	$80,000	
Amount used to pay indebtedness	31,250	
		111,250
Undistributed subchapter A net income (before applying sec. 504 (c))		15,200
Dividends paid March 1, 1953 (subject to limitation in sec. 504 (c) (2))		$8,000
Undistributed subchapter A net income		7,200
Amount taxable at 75 percent (not in excess of $2,000)		2,000
Amount taxable at 85 percent ($7,200 minus $2,000)		5,200
Surtax on $2,000 at 75 percent		1,500
Surtax on $5,200 at 85 percent		4,420
Total surtax		5,920

§ 39.506 *Statutory provisions; credits and refunds for deficiency dividends.*

SEC. 506. *Deficiency dividends—credits and refunds*—(a) *Credit against unpaid deficiency.* If the amount of a deficiency with respect to the tax imposed by this subchapter 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 3760; 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 subchapter 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 3760; 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 purposes of this subchapter, 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 would have been includible in the computation of the basic surtax credit for the taxable year with respect to which the deficiency was asserted if distributed during such taxable year. 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, of this section or section 407 of the Revenue Act of 1938, are allowed) shall be subtracted from the basic surtax credit for such year, but only for the purpose of computing the tax under this subchapter 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, of this section or section 407 of the Revenue Act of 1938, are allowed) shall not be allowed under section 504 (c) in the computation of the tax under this subchapter 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 subchapter 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 subchapter 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.

(g) *Rate for taxable years 1939, 1940, and 1941.* * * *

(h) *Rate for taxable years after 1941.* If the deficiency is established or determined for a taxable year which begins after December 31, 1941, the rates under subsections (a) and (b) used in determining the amount of the credit or refund shall be 75 per centum in lieu of 65 per centum and 85 per centum in lieu of 75 per centum.

(i) *Additional credit or refund for prior taxable year.* * * * [Not applicable].

[Sec. 506 as amended by sec. 1, Pub. Law 18 (77th Cong.); secs. 185, 186 (d) (1), (i), Rev. Act 1942]

§ 39.506-1 *Purpose and scope of deficiency dividend credit.* (a) Section 506 provide a method under which, by virtue of dividend distributions, a corporation may, under certain conditions (see § 39.506-3) be relieved from the payment of a deficiency in the surtax imposed by subchapter A of chapter 2, or, if any portion of such deficiency has been paid, may be entitled, under certain conditions (see § 39.506-4), to a credit or refund of such portion. The deficiency must be established in the manner specified in section 506 (a) (1), (2), or (3) or section 506 (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 § 39.27 (b)-2.

(b) The benefit of section 506 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 if the closing agreement, decision of The Tax Court of the United States, or judgment contains a finding that any part of the deficiency is due 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 506 (f).

§ 39.506-2. *Date when decision by Tax Court or court becomes final and date of closing agreement.* (a) The date upon which a decision by The Tax Court of the United States becomes final is prescribed in section 1140.

(b) 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.

(c) The date of the closing agreement, made under section 3760, is the date such agreement is approved by the Secretary, the Under Secretary, or an Assistant Secretary, except that a closing agreement with respect to a final determination of tax liability for past years becomes final on the date of its approval by the Commissioner.

§ 39.506-3 *Credit against unpaid deficiency*—(a) *In general.* If the amount of a deficiency with respect to the tax imposed by subchapter A of chapter 2 has been established as provided in section 506 (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 506 (d). The amount of the deficiency dividends credit is computed at the rates prescribed in section 506 for the taxable year for which the deficiency was established, and the allowance of the credit is subject to the following conditions, qualifications, and limitations:

(1) The corporation is required under section 506 (c) within 30 days after the date of the closing agreement or the date upon which the decision of The Tax Court of the United States 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 506 (d) within 60 days after the date of the closing agreement or the date upon which the decision of The Tax Court or judgment becomes final, to file a claim with respect to the credit for deficiency dividends;

(3) The deficiency dividends are required under section 506 (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 chapter 1 for the year in which paid (see section 27 (i)) and must be nonpreferential (see section 27 (h)), and

(4) Under section 506 (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 Tax Court 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 506 (a) shall be made with the requisite declaration on Form 975, copies of which, upon request, may be procured from any district director of internal revenue.

(c) *Contents of notification.* The notification shall, in accordance with the provisions of this section 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 subchapter A of chapter 2; how it was established (closing agreement, Tax Court 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 506 (c) (1) and this section shall be filed with the Commissioner of Internal Revenue, Washington 25, D. C., attention Audit Service Branch, Audit Division, within 30 days after the date of the closing agreement, or the date upon which the decision of The Tax Court or judgment becomes final, as the case may be.

(e) *Claim for deficiency dividends credit.* For claims for deficiency dividends credits, see § 39.506-5.

§ 39.506-4 *Credit or refund of deficiency paid.* If the Commissioner has determined that there is a deficiency with respect to the tax imposed by subchapter A of chapter 2 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 computed at the rates prescribed in section 506 for the taxable year for which the deficiency was established, and the allowance of the credit or refund is subject to the following conditions, qualifications, and limitations:

(a) 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 506 (b) (1) (2) or (3)

(b) The corporation is required under section 506 (d) within 60 days after the date of the closing agreement or the date upon which the decision of The Tax Court of the United States or the judgment becomes final, to file a claim for credit or refund,

(c) The "deficiency dividends" are required under section 506 (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 constitute taxable dividends in the hands of such of the shareholders as are subject to taxation under chapter 1 for the year in which paid (see section 27 (i)) and must be nonpreferential (see section 27 (h))

(d) 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;

(e) 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 Tax Court on refunds or credits)

(f) No credit or refund shall be made under section 506 (b) with respect to any amount of tax paid after the date of the closing agreement, or the date the decision of The Tax Court or the judgment becomes final, as the case may be; and

(g) No interest shall be allowed on the credit or refund.

§ 39.506-5 *Claim for deficiency dividends credit or credit or refund.*—(a) *In general.* A claim for a deficiency dividends credit under section 506 (a), relating to credit against unpaid deficiency, and under section 506 (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 Tax Court of the United States 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 with the requisite declaration on Form 976, copies of which, upon request, may be procured from any district director of internal revenue.

(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 section 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 subchapter A of chapter 2 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, Tax Court 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 Tax Court 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 506 (d) and this section shall be filed with the Commissioner of Internal Revenue, Washington 25, D. C., attention Audit Service Branch, Audit Division, within 60 days after the date of the closing agreement, or the date upon which the decision of The Tax Court or judgment becomes final, as the case may be.

§ 39.506-6 *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 506 of the Internal Revenue Code or section 407 of the Revenue Act of 1938 based upon a distribution of "deficiency dividends," that distribution does not become a part of the basic surtax credit for the purposes of subchapter A of chapter 2; nor is it made the basis of the 2½-month carry-back credit provided for in section 504 (c)

§ 39.506-7 *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 506 (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 Internal Revenue Code 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 506, 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 506 (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 506 (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 506 (a) until the date the claim is disallowed (in whole or in part) by the Commissioner. The Code 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 subchapter A 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.

§ 39.507 *Statutory provisions; meaning of terms used.*

SEC. 507. *Meaning of terms used*—(a) *General rule.* The terms used in this subchapter shall have the same meaning as when used in chapter 1.

(b) *Insurance companies other than life or mutual.* Notwithstanding subsection (a), the term "gross income" as used in this subchapter, means, in the case of an insurance company other than life or mutual, the gross income, as defined in section 204 (b) (1), increased by the amount of losses incurred, as defined in section 204 (b) (6), and the amount of expenses incurred, as defined in section 204 (b) (7), and decreased by the amount deductible under section 204 (c) (7) (relating to tax-free interest).

[Sec. 507 as amended by sec. 227 (a), Rev. Act 1939]

§ 39.508 *Statutory provisions; administrative provisions.*

SEC. 508. *Administrative provisions.* All provisions of law (including penalties) applicable in respect of the taxes imposed by chapter 1, shall insofar as not inconsistent with this subchapter, be applicable in respect of the tax imposed by this subchapter, except that the provisions of section 131 shall not be applicable.

§ 39.508–1 *Return and payment of tax.* A separate return is required for the surtax imposed by section 500. 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 chapter 1 also apply to the surtax imposed under subchapter A of chapter 2. However, since the surtax imposed under subchapter A of chapter 2 is a distinct and separate tax from those imposed under chapter 1, the making of a return under chapter 1 will not start the period of limitations for assessment of the surtax imposed under subchapter A of chapter 2. If the corporation subject to section 500 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 500, he is required to follow the same procedure which applies to deficiencies in income tax under chapter 1. The penalties applicable to the income taxes imposed under chapter 1, as well as the provisions of chapter 1 relating to interest and additions to the tax, also apply to the surtax imposed by section 500. The administrative provisions applicable to the surtax imposed by section 500 are not confined to those contained in chapter 1 but embrace all administrative provisions of law which have any application to income taxes.

§ 39.508–2 *Determination of tax, assessment, collection.* The determination, assessment, and collection of the tax imposed by section 500, 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.

§ 39.509–511 *Statutory provisions; improper accumulation of surplus; foreign personal holding companies; publicity of returns; cross references.*

SEC. 509. *Improper accumulation of surplus.* For surtax on corporations which accumulate surplus to avoid surtax on shareholders, see section 102.

SEC. 510. *Foreign personal holding companies.* For provisions relating to foreign personal holding companies and their shareholders, see Supplement P of chapter 1.

SEC. 511. *Publicity of returns.* For provisions with respect to publicity of returns under this subchapter, see subsection (a) (2) of section 55.

SUBPART F—ADMINISTRATIVE PROVISIONS

DISCOVERY OF TAX LIABILITY

§ 39.3604 *Statutory provisions; returns as to formation, etc., of foreign corporation.*

SEC. 3604. *Returns as to formation, etc., of foreign corporations*—(a) *Requirement.* Under regulations prescribed by the Commissioner, with the approval of the Secretary, any attorney, accountant, fiduciary, bank, trust company, financial institution, or other person, who aids, assists, counsels, or advises in, or with respect to, the formation, organization, or reorganization of any foreign corporation, shall, within 30 days thereafter, file with the Commissioner a return.

(b) *Form and contents of return.* Such return shall be in such form, and shall set forth, under oath, in respect of each such corporation, to the full extent of the information within the possession or knowledge or under the control of the person required to file the return, such information as the Commissioner with the approval of the Secretary prescribes by regulations as necessary for carrying out the provisions of the income tax laws. Nothing in this section shall be construed to require the filing by an attorney-at-law of a return with respect to any advice given or information obtained through the relationship of attorney and client.

(c) *Penalty.* Any person required under subsection (a) 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 other penalties provided by law 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.

[Sec. 3604 as amended by sec. 404, Rev. Act 1939]

§ 39.3604–1 *Information returns*—(a) *General.* (1) Any attorney (except as provided in paragraph (b) (4) of this section), accountant, fiduciary, bank, trust company, financial institution, or other person, who aids, assists, counsels, or advises in, or with respect to, the formation, organization, or reorganization of any foreign corporation shall file with the district director of internal revenue for the internal revenue district in which the return of such person must be filed under section 53 within 30 days after giving such aid, assistance, counsel, or advice, an information return as provided in this section and section 3604 (a). The return must be filed in every such case (i) regardless of the nature of the counsel or advice given, whether for or against the formation, organization, or reorganization of the foreign corporation, or the nature of the aid or assistance rendered and (ii) regardless of the action taken upon the advice or counsel, that is, whether the foreign corporation is actually formed, organized, or reorganized.

(2) If, in a particular case, the aid, assistance, counsel, or advice given by any person extends over a period of more than one day and not for more than 30 days, such person, to avoid the multiple filing of returns, may file a single return for the entire period. In such case, the return shall be filed within 30 days from the first day of such period. If, in a particular case, the aid, assistance, counsel, or advice given by any person extends over a period of more than 30 days, such person may file a return at the end of each 30 days included within such period and at the end of the fractional part of a 30-day period, if any, extending beyond the last full 30 days. In each such case, the return must disclose all the required information which was not reported on a prior return.

(b) *Special provisions*—(1) *Employers.* In the case of aid, assistance, counsel, or advice in or with respect to, the formation, organization, or reorganization of a foreign corporation given by a

person in whole or in part through the medium of subordinates or employees (including, in the case of a corporation, the officers thereof) the return of the employer must set forth to the full extent all information prescribed by this section and §§ 39.3604-2 and 39.3604-3, including that which, as an incident to such employment, is within the possession or knowledge or under the control of such subordinates or employees.

(2) *Employees.* The obligation of a subordinate or employee (including, in the case of a corporation, the officers thereof) to file a return with respect to any aid, assistance, counsel, or advice in or with respect to the formation, organization, or reorganization of a foreign corporation, given as an incident to his employment, will be satisfied if a complete and accurate return as prescribed by this section and §§ 39.3604-2 and 39.3604-3 is duly filed by the employer setting forth all of the information within the possession or knowledge or under the control of such subordinate or employee. Clerks, stenographers, and other subordinates or employees, rendering aid or assistance solely of a clerical or mechanical character in or with respect to the formation, organization, or reorganization of a foreign corporation are not required to file returns by reason of such services.

(3) *Partners.* In the case of aid, assistance, counsel, or advice in or with respect to the formation, organization, or reorganization of a foreign corporation given by one or more members of a partnership in the course of its business, the obligation of each such individual member to file a return will be satisfied if a complete and accurate return, as prescribed by this section and §§ 39.3604-2 and 39.3604-3, is duly filed by the partnership, executed by all the members of the firm who gave any such aid, assistance, counsel, or advice. If, however, the partnership has been dissolved at the time the return is due, individual returns must be filed by each member of the former partnership who gave any such aid, assistance, counsel, or advice.

(4) *Attorneys at law.* An attorney at law is not required to file a return with respect to any advice given or information obtained through the relationship of attorney and client.

(5) *Returns jointly made.* If two or more persons aid, assist, counsel, or advise in or with respect to the formation, organization, or reorganization of a particular foreign corporation, any two or more of such persons may, in lieu of filing several returns, jointly execute and file one return.

(c) *Penalties.* For criminal penalties for failure to file the returns required by this section, §§ 39.3604-2 and 39.3604-3, and by section 3604 (a) see section 3604 (c)

§ 39.3604-2 *Form of return.* The returns under § 39.3604-1 shall be made on Form 959. Such forms may, upon request, be procured from any district director of internal revenue. Each person should carefully prepare his return so as to set forth fully and clearly the information called for therein. Returns which have not been so prepared will not be accepted as meeting the requirements of the Code.

§ 39.3604-3 *Contents of returns and verification.* (a) The return shall, in accordance with the provisions of §§ 39.3604-1, 39.3604-2, and this section and the instructions on the form, set forth the following information to the full extent such information is within the knowledge or possession or under the control of the person required to file the return:

(1) The name and address of the person (or persons) to whom and the person (or persons) for whom or on whose behalf the aid, assistance, counsel, or advice was given;

(2) A complete statement of the aid, assistance, counsel, or advice given;

(3) The name and address of the foreign corporation and the country under the laws of which it was formed, organized, or reorganized;

(4) The month and year when the foreign corporation was formed, organized, or reorganized;

(5) A statement of the manner in which the formation, organization, or reorganization of the foreign corporation was effected;

(6) A complete statement of the reasons for, and the purposes sought to be accomplished by, the formation, organization, or reorganization of the foreign corporation;

(7) A statement showing the classes and kinds of assets transferred to the foreign corporation in connection with its formation, organization, or reorganization, including a detailed list of any stock or securities included in such assets, and a statement showing the names and addresses of the persons who were the owners of such assets immediately prior to the transfer;

(8) The names and addresses of the shareholders of the foreign corporation at the time of the completion of its formation, organization, or reorganization, showing the classes of stock and number of shares held by each;

(9) The name and address of the person (or persons) having custody of the books of account and records of the foreign corporation; and

(10) Such other information as may be required by the return form.

(b) If a person aids, assists, counsels, or advises in or with respect to the formation, organization, or reorganization of more than one foreign corporation, a separate return must be filed with respect to each foreign corporation.

(c) Every return shall contain or be verified by a written declaration that it is made under the penalties of perjury.

DETERMINATION OF TAX LIABILITY

§ 39.3612 *Statutory provisions; returns executed by Commissioner or district director*

SEC. 3612. *Returns executed by Commissioner or collector*—(a) *Authority of collector* If any person fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise.

(b) *Authority of Commissioner.* In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise—

(1) *To make return.* Make a return, or

(2) *To amend collector's return.* Amend any return made by a collector or deputy collector.

(c) *Legal status of returns.* Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes.

(d) *Additions to tax.* * * *

(3) *Gross reference.* For additions to tax in the case of income tax, see sections 291 and 293 * * *

(e) * * *

(f) *Determination and assessment.* The Commissioner shall determine and assess all taxes, other than stamp taxes, as to which returns or lists are so made under the provisions of this section.

§ 39.3614-3617 *Statutory provisions; examination of books and witnesses; summons from district director to produce books and give testimony; penalties; penalties and awards to informers with respect to illegally produced petroleum.*

SEC. 3614. *Examination of books and witnesses.*—(a) *To determine liability of the taxpayer.* The Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is authorized, by any officer or employee of the Bureau of Internal Revenue, including the field service, designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

(b) *To determine liability of a transferee.* The Commissioner, for the purpose of determining the liability at law or in equity of a transferee of the property of any person with respect to any Federal taxes imposed upon such person, is hereby authorized, by any officer or employee of the Bureau of Internal Revenue, including the field service, designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon such liability, and may require the attendance of the transferor or transferee, or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter, with power to administer oaths to such person or persons.

SEC. 3615. *Summons from collector to produce books and give testimony*—(a) *General authority.* It shall be lawful for the collector, subject to the provisions of this section to summon any person to appear before him and produce books at a time and place named in the summons, and to give testimony or answer interrogatories, under oath, respecting any objects or income liable to tax or the returns thereof. The collector may summon any person residing or found within the State or Territory in which his district lies; and when the person intended to be summoned does not reside and can not be

found within such State or Territory, he may enter any collection district where such person may be found and there make the examination herein authorized. And to this end he may there exercise all the authority which he might lawfully exercise in the district for which he was commissioned.

(b) *Acts creating liability.* Such summons may be issued—

(1) *Refusal or neglect to comply with notice requiring return.* If any person, on being notified or required as provided in section 3611 shall refuse or neglect to render such list or return within the time required, or

(2) *Failure to render return on time.* Whenever any person who is required to deliver a monthly or other return of objects subject to tax fails to do so at the time required, or

(3) *Erroneous, false, or fraudulent return.* Whenever any person who is required to deliver a monthly or other return of objects subject to tax delivers any return which, in the opinion of the collector, is erroneous, false, or fraudulent, or contains any undervaluation or understatement, or

(4) *Refusal to permit examination of books.* Whenever any person who is required to deliver a monthly or other return of objects subject to tax refuses to allow any regularly authorized Government officer to examine his books.

(c) *Persons liable.* Such summons may be issued to—

(1) *Persons mentioned in subsection (b).* Any person mentioned in subsection (b), or

(2) *Persons having books.* Any other person having possession, custody, or care of books of account containing entries relating to the business of any person mentioned in subsection (b), or

(3) *Other persons.* Any other person the collector may deem proper.

(d) *Service.* Such summons shall in all cases be served by a deputy collector of the district where the person to whom it is directed may be found, by an attested copy delivered to such person in hand, or left at his last and usual place of abode, allowing such person one day for each twenty-five miles he may be required to travel, computed from the place of service to the place of examination; and the certificate of service signed by such deputy shall be evidence of the facts it states on the hearing of an application for an attachment. When the summons requires the production of books, it shall be sufficient if such books are described with reasonable certainty.

(e) *Enforcement.* Whenever any person summoned under this section neglects or refuses to obey such summons, or to give testimony, or to answer interrogatories as required, the collector may apply to the judge of the district court or to a United States commissioner for the district within which the person so summoned resides for an attachment against him as for a contempt. It shall be the duty of the judge or commissioner to hear the application, and, if satisfactory proof is made, to issue an attachment, directed to some proper officer, for the arrest of such person, and upon his being brought before him to proceed to a hearing of the case; and upon such hearing the judge or the United States commissioner shall have power to make such order as he shall deem proper not inconsistent with the law for the punishment of contempts, to enforce obedience to the requirements of the summons and to punish such person for his default or disobedience.

SEC. 3616. *Penalties.* Whenever any person—

(a) *False returns.* Delivers or discloses to the collector or deputy any false or fraudulent list, return, account, or statement, with intent to defeat or evade the valuation, enumeration, or assessment intended to be made; or,

(b) *Neglect to obey summons.* Being duly summoned to appear to testify, or to appear and produce books as required under section 3615, neglects to appear or to produce said books—

he shall be fined not exceeding $1,000, or be imprisoned not exceeding one year, or both, at the discretion of the court, with costs of prosecution.

(c) *Cross reference.* * * *

SEC. 3617. *Penalties and awards to informers with respect to illegally produced petroleum*—(a) *Failure to file return.* Any person liable for tax on any income from illegally produced petroleum, who willfully fails to make return showing such income within the time prescribed by law shall, in addition to all other penalties prescribed by law, be liable to a civil penalty of $500 plus $50 for each day during which such failure continues.

(b) *Reward for information.* Any person not an officer or employee of the United States who furnishes to the Commissioner or any collector original information leading to the recovery from any other person of any penalty under this section may be awarded and paid by the Commissioner a compensation of one-half the penalty so recovered, as determined by the Commissioner.

(c) *Income defined.* As used in this section, the term "income from illegally produced petroleum" means any income (not shown on a return made within the time prescribed by law) arising out of any sale or purchase of crude petroleum withdrawn from the ground subsequent to January 1, 1932, in violation of any State or Federal law (not including illegal withdrawal the penalties for which have been mitigated or satisfied in pursuance of law prior to May 10, 1934), or arising out of any fee derived from acting as agent for any seller or purchaser in connection with a sale or purchase of such petroleum or products thereof, or any amount illegally received by any person charged with the enforcement of law with respect to such petroleum or products thereof.

MISCELLANEOUS PROVISIONS

§ 39.3631–3633 *Statutory provisions; restriction on examination of taxpayers; authority to administer oaths, take testimony, and certify; jurisdiction of district courts to enforce summons, etc.*

SEC. 3631. *Restrictions on examination of taxpayers.* No taxpayer shall be subjected to unnecessary examinations or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

SEC. 3632. *Authority to administer oaths, take testimony, and certify*—(a) *Internal revenue personnel*—(1) *Persons in charge of administration of internal revenue laws generally.* Every collector, deputy collector, internal revenue agent, and internal revenue officer assigned to duty under an internal revenue agent, is authorized to administer oaths and to take evidence touching any part of the administration of the internal revenue laws with which he is charged, or where such oaths and evidence are authorized by law or regulation authorized by law to be taken.

(2) *Persons in charge of exports and drawbacks.* Every collector of internal revenue and every superintendent of exports and drawbacks is authorized to administer such oaths and to certify to such papers as may be necessary under any regulation prescribed under the authority of the internal revenue laws.

(b) *Others.* Any oath or affirmation required or authorized by any internal revenue law or by any regulations made under authority thereof may be administered by any person 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 any consular officer of the United States. This subsection shall not be construed as an exclusive enumeration of the persons who may administer such oaths or affirmations.

SEC. 3633. *Jurisdiction of district courts*—(a) *To enforce summons.* If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

(b) *To issue orders, processes, and judgments.* For authority of district courts to issue orders, processes, and judgments for enforcement of internal revenue laws, see section 3799 [3800].

GENERAL COLLECTION PROVISIONS

§ 39.3653 *Statutory provisions; prohibition of suits to restrain assessment or collection of tax.*

SEC. 3653. *Prohibition of suits to restrain assessment or collection*—(a) *Tax.* Except as provided in sections 272 (a), 871 (a), and 1012 (a), no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court.

(b) *Liability of transferee or fiduciary.* No suit shall be maintained in any court for the purpose of restraining the assessment or collection of (1) the amount of the liability, at law or in equity, of a transferee of property of a taxpayer in respect of any income, war-profits, excess-profits, or estate tax, (2) the amount of the liability, at law or in equity, of a transferee of property of a donor in respect of any gift tax, or (3) the amount of the liability of a fiduciary under section 3467 of the Revised Statutes (U. S. C., Title 31, sec. 192) in respect of any such tax.

§ 39.3656 *Statutory provisions; payment by check and money orders.*

SEC. 3656. *Payment by check and money orders*—(a) *Certified, cashiers', and treasurers' checks and money order*—(1) *Authority to receive.* It shall be lawful for collectors to receive for internal revenue taxes or in payment of stamps to be used in payment of internal revenue taxes certified, cashiers', and treasurers' checks drawn on National and State banks and trust companies, and United States postal, bank, express, and telegraph money orders, during such time and under such regulations as the Commissioner, with the approval of the Secretary, may prescribe.

(2) *Discharge of liability*—(A) *Check duly paid.* No person who may be indebted to the United States on account of internal revenue taxes or stamps used or to be used in payment of internal revenue taxes who shall have tendered a certified, cashier's, or treasurer's check or money order as provisional payment therefor, in accordance with the terms of this subsection, shall be released from the obligation to make ultimate payment thereof until such certified,

cashier's, or treasurer's check or money order so received has been duly paid.

(B) *Check unpaid.* If any such check or money order so received is not duly paid, the United States shall, in addition to its right to exact payment from the party originally indebted therefor, have a lien for the amount of such check upon all the assets of the bank on which drawn or for the amount of such money order upon all the assets of the issuer thereof; and such amount shall be paid out of its assets in preference to any or all other claims whatsoever against said bank or issuer except the necessary costs and expenses of administration and the reimbursement of the United States for the amount expended in the redemption of the circulating notes of such bank.

(b) *Other checks*—(1) *Authority to receive.* Collectors may receive checks in addition to those specified in subsection (a) in payment of taxes other than those payable by stamp during such time and under such rules and regulations as the Commissioner, with the approval of the Secretary, shall prescribe.

(2) *Ultimate liability.* If a check so received is not paid by the bank on which it is drawn the person by whom such check has been tendered shall remain liable for the payment of the tax and for all legal penalties and additions to the same extent as if such check had not been tendered.

[Sec. 3656 as amended by Pub. Law 541 (78th Cong.)]

§ 39.3656–1 *Tax paid by check.* District directors of internal revenue may accept uncertified checks in payment of income, war-profits, and excess-profits taxes, provided such checks are collectible at par, that is, for their full amount, without any deduction for exchange or other charges. The district director will stamp on the face of each check before deposit the words "This check is in payment of an obligation to the United States and must be paid at par. No protest," with his name and title. The day on which the district director receives the check will be considered the date of payment, so far as the taxpayer is concerned, unless the check is returned dishonored. If one check is remitted to cover two or more persons' taxes, the remittance must be accompanied by a letter of transmittal stating—

(a) The name of the drawer of the check;

(b) The amount of the check;

(c) The amount of any cash, money order, or other instrument included in the same remittance;

(d) The name of each person whose tax is to be paid by the remittance;

(e) The amount of the payment on account of each person; and

(f) The kind of tax paid.

§ 39.3657 *Statutory provisions; payment of tax by United States notes and certificates of indebtedness.*

SEC. 3657. *Payment by United States notes and certificates of indebtedness.* Collectors may receive, at par with an adjustment for accrued interest, notes or certificates of indebtedness issued by the United States in payment of income, war profits, and excess profits taxes, and any other taxes payable other than by stamp, during such time and under such rules and regulations as the Commissioner, with the approval of the Secretary, shall prescribe.

§ 39.3657–1 *Treasury certificates of indebtedness, Treasury notes, and Treasury bills in payment of income and profits taxes.* (a) Treasury certificates of indebtedness, Treasury notes, or Treasury bills of any series (not including interim receipts issued by Federal reserve banks in lieu of definitive certificates, notes, or bills) may be tendered at or before maturity in payment of income or profits taxes payable under the provisions of the Internal Revenue Code, due on the date on which the certificates, notes, or bills mature or a specified prior date, but only if such certificates, notes, or bills, according to the express terms of their issue, are made acceptable in payment of such income or profits taxes. If the taxes for which the certificates, notes, or bills are tendered in payment become due on the same date as that on which such certificates, notes, or bills mature, they will be accepted at par plus accrued interest, if any, payable with the principal (not represented by coupons attached) in payment of such taxes. If the taxes for which the certificates, notes, or bills are tendered in payment become due on a date prior to that on which the certificates, notes, or bills mature, they will be accepted at the value specified in the terms under which such certificates, notes, or bills were issued. All interest coupons attached to Treasury certificates of indebtedness or Treasury notes shall be detached by the taxpayer before such certificates or notes are tendered in payment of taxes.

(b) Receipts given by a district director of internal revenue for Treasury certificates of indebtedness, Treasury notes, or Treasury bills received in payment of income or profits taxes as provided in this section shall contain an adequate description of such certificates, notes, or bills, and a statement of the value, including accrued interest, if any, payable with the principal (not represented by coupons attached) at which accepted, and shall show that the certificates, notes, or bills are tendered by the taxpayer and received by the district director, subject to no condition, qualification, or reservation whatsoever, in payment of an amount of taxes no greater than such value. Any certificate, note, or bill offered in payment of income or profits taxes under the provisions of the Internal Revenue Code subject to any condition, qualification, or reservation, or for any greater amount than the value at which acceptable in payment of taxes, as specified in the terms under which such certificate, note, or bill was issued, shall not be deemed to be duly tendered and shall be returned to the taxpayer.

(c) For the purpose of saving taxpayers the expense of transmitting such Treasury certificates of indebtedness, Treasury notes, or Treasury bills to the office of the district director of internal revenue in whose district the taxes are payable, taxpayers desiring to pay income or profits taxes with such certificates, notes, or bills acceptable in payment of taxes may deposit such certificates, notes, or bills with a Federal reserve bank or branch, subject to the condition that the Federal reserve bank or branch shall issue a receipt in the name of the district director of internal revenue, describing the certificates, notes, or bills by par or dollar face amount and stating on the face of the receipt that the certificates, notes, or bills represented thereby are held by the bank or branch for redemption at the value specified in the terms under which the certificates, notes, or bills were issued, and application of the proceeds in payment of income or profits taxes due on a specified date by the taxpayer named therein.

§ 39.3657–2 *Acceptance of Treasury Savings Notes, Series A, Series B, and Series D, in payment of income (including excess profits) taxes.* (a) (1) Notes of the United States designated as Treasury Savings Notes, Series A, Series B, and Series D, may be accepted in payment of income taxes (current and back personal and corporation taxes, and excess profits taxes) at par and accrued interest (but no accrual beyond the maturity date) In the case of Treasury Savings Notes, Series D, interest will be accrued to the month, inclusive, in which presented. In the case of Treasury Savings Notes, Series A and Series B, interest will be accrued to the day when the taxes are due, if such day falls on the fifteenth day of a calendar month, whether the notes are received on or before that day; if the taxes are due on any other day of the month than the fifteenth, accrued interest will be credited to the accrual date next preceding the day when the taxes are due. District directors of internal revenue are authorized and directed to accept Treasury Savings Notes, Series A and Series D, at any time and to accept Treasury Savings Notes, Series B, at any time after two months from the issue date. For example, a Treasury Savings Note, Series B, dated July 15, 1953, may be presented for credit against taxes due September 15, 1953, but a note dated August 15, 1953, may not be accepted for credit against taxes due before October 15, 1953.

(2) Such notes may be accepted only in payment of income (including excess profits) taxes (current and back) due from the original purchaser thereof or his estate. Such notes shall be in the name of the taxpayer (individual, corporation, or other entity) and may be presented for tax payment by only the taxpayer, his agent, or his estate. There is no limit upon the amount of such notes which may be accepted in payment of income (including excess profits) taxes.

(3) Such notes, inscribed in the name of a taxpayer, may be accepted in payment of income tax withheld at the source by such taxpayer and such notes inscribed in the name of a taxpayer may be accepted in payment of transferee liability assessed against such taxpayer for income (including excess profits) taxes.

(b) District directors of internal revenue shall not in any case allow credit to a taxpayer on account of such notes, or accept such notes, for an amount greater than their principal amount plus accrued interest, nor shall such notes be accepted in an amount (including accrued in-

terest) greater than the unpaid liability of the taxpayer. Such notes shall be forwarded to the district director of internal revenue with whom the tax return is filed, at the risk and expense of the taxpayer, and, for the taxpayer's protection, should be forwarded by registered mail, if not presented in person.

§ 39.3658 *Statutory provisions; fractional parts of a cent.*

SEC. 3658. *Fractional parts of a cent.* In the payment of any tax under this title not payable by stamp 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.

§ 39.3661 *Statutory provisions; enforcement of liability for taxes collected or withheld.*

SEC. 3661. *Enforcement of liability for taxes collected.* Whenever any person is required to collect or withhold any internal-revenue tax from any other person and to pay such tax over to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

LIEN FOR TAXES

§ 39.3670–3673 *Statutory provisions; property subject to lien; period of lien, validity against mortgagees, pledgees, purchasers, and judgment creditors; release of lien.*

SEC. 3670. *Property subject to lien.* If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

SEC. 3671. *Period of lien.* Unless another date is specifically fixed by law, the lien shall arise at the time the assessment list was received by the collector and shall continue until the liability for such amount is satisfied or becomes unenforceable by reason of lapse of time.

SEC. 3672. *Validity against mortgagees, pledgees, purchasers, and judgment creditors*—(a) *Invalidity of lien without notice.* Such lien shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the collector—

(1) *Under State or Territorial laws.* In the office in which the filing of such notice is authorized by the law of the State or Territory in which the property subject to the lien is situated, whenever the State or Territory has by law authorized the filing of such notice in an office within the State or Territory; or

(2) *With clerk of district court.* In the office of the clerk of the United States district court for the judicial district in which the property subject to the lien is situated, whenever the State or Territory has not by law authorized the filing of such notice in an office within the State or Territory; or

(3) *With clerk of District Court of the United States for the District of Columbia.* In the office of the clerk of the District Court of the United States for the District of Columbia, if the property subject to the lien is situated in the District of Columbia.

(b) (1) *Exception in case of securities.* Even though notice of a lien provided in section 3670 has been filed in the manner prescribed in subsection (a) of this section, or notice of a lien provided in section 3186 of the Revised Statutes, as amended, has been filed in the manner prescribed in such section or subsection (a) of this section, the lien shall not be valid with respect to a security, as defined in paragraph (2) of this subsection, as against any mortgagee, pledgee, or purchaser, of such security, for an adequate and full consideration in money or money's worth, if at the time of such mortgage, pledge, or purchase such mortgagee, pledgee, or purchaser is without notice or knowledge of the existence of such lien.

(2) *Definition of security.* As used in this subsection the term "security" means 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, share of stock, voting trust certificate, or any certificate of interest or participation in, certificate of deposit or receipt for, temporary or interim certificate for, or warrant or right to subscribe to or purchase, any of the foregoing; negotiable instrument; or money.

(3) *Applicability of subsection.* Except where the lien has been enforced by a proceeding, suit, or civil action which has become final before the date of enactment of the Revenue Act of 1939, this subsection shall apply regardless of the time when the mortgage, pledge, or purchase was made or the lien arose.

[Sec. 3672 as amended by sec. 401, Rev. Act 1939; sec. 505, Rev. Act 1942]

SEC. 3673. *Release of lien.* Subject to such regulations as the Commissioner, with the approval of the Secretary, may prescribe, the collector charged with an assessment in respect of any tax, may issue a certificate of release of the lien if—

(a) *Liability satisfied or unenforceable.* The collector finds that the liability for the amount assessed, together with all interest in respect thereof, has been satisfied or has become unenforceable by reason of lapse of time; or

(b) *Bond accepted.* There is furnished to the collector and accepted by him a bond that is conditioned upon the payment of the amount assessed, together with all interest in respect thereof, within the time prescribed by law (including any extension of such time), and that is in accordance with such requirements relating to terms, conditions, and form of the bond and sureties thereon, as may be specified in the regulations.

§ 39.3673–1 *Release of liens*—(a) *Liability satisfied or unenforceable.* The district director of internal revenue to whom is charged an assessment in respect of any internal revenue tax shall issue a certificate of release of the tax lien whenever he finds that the liability for the amount assessed (together with all interest in respect thereof) has been satisfied or has become unenforceable. The word "unenforceable" as here used means unenforceable as a matter of law, and not merely uncollectible or unenforceable as a matter of fact. Tax liabilities frequently are unenforceable in fact for the time being, due to the temporary nonpossession by the taxpayer of discoverable property or property rights. In all cases the liability for the payment of the tax continues until satisfaction of the tax in full or until the expiration of the statutory period for collection, including such period as the taxpayer by consent in writing may agree with the Commissioner shall constitute the time within which the tax assessed may lawfully be collected. District directors should continue to investigate carefully all cases of delinquent taxpayers where notice of lien has been filed with a view of obtaining, before the expiration of the collection period, such written consent for the extension of the collection period, whenever it is reasonably possible that the taxpayer may, in the future, acquire property or property rights from which the tax liability may be satisfied.

(b) *Bond accepted.* The district director may in his discretion issue a certificate of release of the tax lien if he is furnished and accepts a bond that is conditioned upon the payment of the amount assessed (together with all interest in respect thereof) within the time agreed upon in the bond, but not later than 6 months before the expiration of the statutory period for collection, including any period for collection agreed upon in writing by the Commissioner and the taxpayer. The form of any bond so furnished shall be the standard form (Form 1131) entitled "Bonds for Release of Federal Tax Lien." Such 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, except that, when specifically authorized by the Commissioner, such bond may be executed by a surety or sureties, individual or corporate, other than a surety company.

§ 39.3674 *Statutory provisions; partial discharge of property.*

SEC. 3674. *Partial discharge of property*—(a) *Property double the amount of the liability.* Subject to such regulations as the Commissioner, with the approval of the Secretary, may prescribe, the collector charged with an assessment in respect of any tax may issue a certificate of partial discharge of any part of the property subject to the lien if the collector finds that the fair market value of that part of such property remaining subject to the lien is at least double the amount of the liability remaining unsatisfied in respect of such tax and the amount of all prior liens upon such property.

(b) *Part payment.* Subject to such regulations as the Commissioner, with the approval of the Secretary, may prescribe, the collector charged with an assessment in respect of any tax may issue a certificate of discharge of any part of the property subject to the lien if there is paid over to the collector in part satisfaction of the liability in respect of such tax an amount determined by the Commissioner, which shall not be less than the value, as determined by him, of the interest of the United States in the part to be so discharged. In determining such value the Commissioner shall give consideration to the fair market value of the part to be so discharged and to such liens thereon as have priority to the lien of the United States.

§ 39.3674–1 *Partial discharge of property*—(a) *Remaining property double the amount of liability.* The district director may in his discretion issue a certificate of discharge of any part of the property subject to the tax lien if he finds that the fair market value of the part of the property not released from

such lien is at least double the amount of the existing liability in respect of such tax plus double the amount of all liens prior to that of the tax lien. In general, fair market value is that amount which one ready and willing but not compelled to buy would pay to another ready and willing but not compelled to sell the property. District directors must be conservative in determining property values and should make careful inquiry with respect thereto.

(b) *Part payment of liability.* (1) In no case shall a certificate discharging property from a Federal tax lien be issued under the provisions of section 3674 (b) unless there is first made a payment in such amount as the Commissioner has determined, to be applied towards satisfaction of the tax liability which gave rise to the Federal lien. In determining the amount to be paid, the Commissioner will take into consideration all the facts and circumstances of the case, including the expenses to which the Government has been put in the matter. In no case shall the amount to be paid be less than the value of the interest of the United States in the property with respect to which the certificate of discharge is issued, as such value has been determined by the Commissioner in the light of the fair market value of the property and the amount of all liens and encumbrances thereon having priority over the Federal tax lien.

(2) Any person desiring that a certificate discharging property from a Federal tax lien be issued under the provisions of section 3674 (b) should present to the district director of internal revenue charged with the assessment in respect of the tax, a written application requesting that the certificate be issued. Such application should give the reasons for the request, and should clearly describe the property with respect to which the discharge is desired. In support of the request, the applicant must furnish the district director with proof sufficient to establish satisfactorily the fair market value of the property, the amounts, character, and dates (both of execution and of record) of all encumbrances of record prior to the Federal lien, as well as the amount and character of any unrecorded encumbrances believed to be prior to the Federal lien (including information as to how and when all such encumbrances arose) Appropriate references must be made to the pages and volumes of the recording books in which any such encumbrances have been recorded.

(3) The district director should review the proof, check the accuracy of all material statements made and forward to the Commissioner a report of the case together with his recommendation. The district director's report should include a statement of the expenses of his office incident to the placing and discharging of the lien as well as his conclusions with respect to the fair market value of the property involved and the value of the Government's interest therein, viewed in the light of such fair market value and the amount of liens and encumbrances on the property believed to have priority over the lien of the United States. Information as to the nature and amount of such encumbrances sufficient to enable a determination to be made whether, as a matter of law, they actually have priority over the Government's lien, should be included in the report.

(4) The report of the district director should also show the year or years and the dates of all assessments involved, the lists on which such assessments appear and the amounts thereof, the office or offices in which, and the dates when, notices of the Federal tax lien or liens were filed, and any payments made in partial satisfaction of the tax liability. In his discretion, the district director may submit with his report whatever documentary evidence he deems to be relevant. Upon receipt of the district director's report and recommendation, the question whether a certificate of discharge may be issued and the amount to be paid as a prerequisite to its issuance, will be considered.

(5) When so authorized by the Commissioner, the district director may issue a certificate discharging from the Federal tax lien such property as the Commissioner has authorized to be discharged, provided the amount determined by the Commissioner as a prerequisite to the issuance of the certificate is first paid to the district director to be applied by him towards satisfaction of the tax.

§ 39.3675–3676 *Statutory provisions; effect of certificates of release or partial discharge; single bond covering release of lien and payment of income tax deficiency.*

SEC. 3675. *Effect of certificates of release or partial discharge.* A certificate of release or of partial discharge issued under this subchapter [subchapter B of chapter 36] shall be held conclusive that the lien upon the property covered by the certificate is extinguished.

SEC. 3676. *Single bond covering release of lien and payment of income tax deficiency.* The Commissioner, with the approval of the Secretary, may by regulation provide for the acceptance of a single bond complying both with the requirements of section 272 (j) (relating to the extension of time for the payment of a deficiency) and the requirements of subsection (b) of section 3673.

§ 39.3676–1 *Single bond covering release of lien and payment of deficiency.* In cases where the district director issues a certificate of release of tax lien and at the same time an extension of time is granted for the payment of the deficiency in tax pursuant to the provisions of section 272 (j) a single bond may be accepted by the district director conditioned upon the payment of the amount assessed (together with all interest in respect thereof) in accordance with the terms of the extension and not later than 6 months prior to the expiration of the statutory period for collection including any period for collection agreed upon in writing by the Commissioner and the taxpayer. Form 1131 shall be used in these cases and shall be modified to meet the circumstances. Where a certificate of release of the tax lien has been issued by the district director and the bond furnished to and accepted by the district director fully protects the interests of the United States with respect to the tax assessed, no additional bond will be required by the Commissioner as a condition to the granting of an extension of time for the payment of the deficiency in tax under the provisions of section 272 (j)

§ 39.3677–3680 *Statutory provisions; extended application of provisions relating to release or partial discharge; civil action to enforce lien on property; civil action to clear title to realty; cross references.*

SEC. 3677. *Extended application of provisions relating to release or partial discharge.* Sections 3673, 3674, 3675, and 3676 shall apply to a lien in respect of any internal revenue tax, whether or not the lien is imposed by this subchapter [subchapter B of chapter 36].

SEC. 3678. *Civil action to enforce lien on property*—(a) *Filing.* In any case where there has been a refusal or neglect to pay any tax, and it has become necessary to seize and sell property and rights to property, whether real or personal, to satisfy the same, whether distraint proceedings have been commenced or not, the Attorney General at the request of the Commissioner may direct a civil action to be filed, in a district court of the United States, to enforce the lien of the United States for tax upon any property and rights to property, whether real or personal, or to subject any such property and rights to property owned by the delinquent, or in which he has any right, title, or interest, to the payment of such tax.

(b) *Parties to proceedings.* All persons having liens upon or claiming any interest in the property or rights to property sought to be subjected as aforesaid shall be made parties to such proceedings and be brought into court.

(c) *Adjudication and decree.* The said court shall, at the term next after the parties have been duly notified of the proceedings, unless otherwise ordered by the court, proceed to adjudicate all matters involved therein and finally determine the merits of all claims to and liens upon the property and rights to property in question, and, in all cases where a claim or interest of the United States therein is established, may decree a sale of such property and rights to property, by the proper officer of the court, and a distribution of the proceeds of such sale according to the findings of the court in respect to the interests of the parties and of the United States.

(d) *Receivership.* In any such proceeding, at the instance of the United States, the court may appoint a receiver to enforce the lien, or, upon certification by the Commissioner during the pendency of such proceedings that it is in the public interest, may appoint a receiver with all the powers of a receiver in equity.

SEC. 3679. *Civil action to clear title to realty*—(a) *Obtaining leave to file*—(1) *Request for institution of proceedings by United States.* Any person having a lien upon or any interest in the real estate referred to in section 3678, notice of which has been duly filed of record in the jurisdiction in which the real estate is located, prior to the filing of notice of the lien of the United States as provided in section 3672, or any person purchasing the real estate at a sale to satisfy such prior lien or interest, may make written request to the Commissioner to authorize the filing of a civil action as provided in section 3678.

(2) *Petition to court.* If the Commissioner fails to authorize the filing of such civil action within six months after receipt of such written request, such person or purchaser may, after giving notice to the Commissioner, file a petition in the district court of the United States for the district in which the real estate is located, praying leave to file a civil action for a final determination of all claims to or liens upon the real estate in question.

(3) *Court order.* After a full hearing in open court, the district court may in its discretion enter an order granting leave to file such civil action, in which the United States and all persons having liens upon or claiming any interest in the real estate shall be made parties.

(b) *Service on United States.* Service on the United States shall be had in the manner provided by sections 5 and 6 of the Act of March 3, 1887, entitled "An Act to provide for the bringing of suits against the Government of the United States," c. 359, 24 Stat. 506 (U. S. C., Title 28, secs. 762, 763), as amended.

(c) *Adjudication.* Upon the filing of such civil action the district court shall proceed to adjudicate the matters involved therein, in the same manner as in the case of civil actions filed under section 3678. For the purpose of such adjudication, the assessment of the tax upon which the lien of the United States is based shall be conclusively presumed to be valid.

(d) *Costs.* All costs of the proceedings on the petition and the civil action shall be borne by the person filing the civil action.

SEC. 3680. *Cross references.* * * * For provisions permitting the United States to be made party defendant in a proceeding in a State court for the foreclosure of a lien upon real estate where the United States may have a claim upon the premises involved, see Act of March 4, 1931, c. 515, 46 Stat. 1528 (U. S. C., Title 28, secs. 901-906).

DISTRAINT

§ 39.3690–3695 *Statutory provisions; authority to distrain, property exempt from distraint; levy; proceedings on distraint; priority of specific tax liability on distrained property; purchase and sale of property for account of the United States.*

SEC. 3690. *Authority to distrain.* If any person liable to pay any taxes neglects or refuses to pay the same within ten days after notice and demand, it shall be lawful for the collector or his deputy to collect the said taxes, with such interest and other additional amounts as are required by law, by distraint and sale, in the manner provided in this subchapter [subchapter C of chapter 36], of the goods, chattels, or effects, including stocks, securities, bank accounts, and evidences of debt, of the person delinquent as aforesaid.

SEC. 3691. *Property exempt from distraint*—(a) *Enumeration.* There shall be exempt from distraint and sale, if belonging to the head of a family—

(1) *School books and wearing apparel.* The school books and wearing apparel necessary for such family; also

(2) *Arms.* Arms for personal use;

(3) *Livestock.* One cow, 2 hogs, 5 sheep and the wool thereof, provided the aggregate market value of said sheep shall not exceed $50;

(4) *Fodder.* The necessary food for such cow, hogs, and sheep, for a period not exceeding thirty days;

(5) *Fuel.* Fuel to an amount not greater in value than $25;

(6) *Provisions.* Provisions to an amount not greater than $50;

(7) *Household furniture.* Household furniture kept for use to an amount not greater than $300; and

(8) *Books and tools of trade or profession.* The books, tools, or implements, of a trade or profession, to an amount not greater than $100.

(b) *Appraisal.* The officer making the distraint shall summon three disinterested householders of the vicinity, who shall appraise and set apart to the owner the amount of property herein declared to be exempt.

SEC. 3692. *Levy.* In case of neglect or refusal under section 3690, the collector may levy, or by warrant may authorize a deputy collector to levy, upon all property and rights to property, except such as are exempt by the preceding section, belonging to such person, or on which the lien provided in section 3670 exists, for the payment of the sum due, with interest and penalty for nonpayment, and also of such further sum as shall be sufficient for the fees, costs, and expenses of such levy.

SEC. 3693. *Proceedings on distraint.* When distraint is made, as provided in section 3690—

(a) *Account and notice to owner.* The officer charged with the collection shall make or cause to be made an account of the goods or effects distrained, a copy of which, signed by the officer making such distraint, shall be left with the owner or possessor of such goods or effects, or at his dwelling or usual place of business, with some person of suitable age and discretion, if any such can be found, with a note of the sum demanded and the time and place of sale; and

(b) *Public notice.* Forthwith cause a notification to be published in some newspaper within the county wherein said distraint is made, if a newspaper is published in said county, or to be publicly posted at the post office, if there be one within five miles nearest to the residence of the person whose property shall be distrained, and in not less than two other public places. Such notice shall specify the articles distrained, and the time and place for the sale thereof.

(c) *Time and place of sale.* The time of sale shall not be less than ten nor more than twenty days from the date of such notification to the owner or possessor of the property and the publication or posting of such notice as provided in subsection (b) and the place proposed for the sale shall not be more than five miles distant from the place of making such distraint.

(d) *Adjournment of sale.* Said sale may be adjourned from time to time by said officer, if he deems it advisable, but not for a time to exceed in all thirty days.

SEC. 3694. *Priority of specific tax liability on distrained property.* When property subject to tax, but upon which the tax has not been paid, is seized upon distraint and sold, the amount of such tax shall, after deducting the expenses of such sale, be first appropriated out of the proceeds thereof to the payment of the tax. And if no assessment of such tax has been made upon such property, the collector shall make a return thereof in the form required by law, and the Commissioner shall assess the tax thereon.

SEC. 3695. *Property for account of the United States*—(a) *Purchase.* When any personal property is advertised for sale under distraint as aforesaid, the officer making the seizure shall proceed to sell such property at a public auction, offering the same at a minimum price, including the expenses of making the levy and of advertising the sale, and if the amount bid for such property at the sale is not equal to the minimum price so fixed, the officer conducting the sale may declare the same to be purchased by him for the United States.

(b) *Sale.* The property so purchased may be sold by the collector within whose district the sale was made under such regulations as may be prescribed by the Commissioner, with the approval of the Secretary.

(c) *Accounting.* The collector shall render to the Commissioner a distinct account of all charges incurred in such sales, and, in case of resale, shall pay into the Treasury the proceeds as provided in section 3971.

§ 39.3695–1 *Disposition of distrained property*—(a) *Sale of personal property seized under distraint.* (1) When personal property is seized by an internal revenue officer under a warrant of distraint, and is to be offered for sale at public auction, such officer shall fix a minimum price for the property, including the expenses of levy and the cost of advertising, and shall not accept a bid at such sale less than such minimum price. If the amount bid for the property at the sale is not equal to such minimum price the officer conducting the sale may, in his discretion, declare the property to be purchased for the United States at such minimum price, or may adjourn the sale in accordance with section 3693. If at such sale, or adjourned sale, the property be neither sold to a bidder, nor purchased for the United States, it may again be offered for sale in accordance with the procedure outlined in section 3693, in which event the officer holding the sale may fix a new minimum price for the property.

(2) In fixing the minimum price, the officer charged with this duty must exercise the greatest care in order that a loss may be avoided if the property should be purchased for the United States and resold. The officer making the sale should likewise use extreme caution in declaring the property purchased for the United States. Only such property as appears to have a resale value at or above the minimum price fixed should be bid in for the United States.

(b) *Resale after purchase for the United States.* (1) When such personal property has been declared purchased for the United States, the district director for the internal revenue district in which the property was seized should make every effort to sell it at public sale. Tentative and informal bids from prospective purchasers may be procured. When the property is offered for resale, the highest of such bids should be used as an opening bid at the sale. If no such tentative bid can be procured, it is unlikely that the property would find a purchaser at a public sale. Whether under such circumstances the sale should be made rests in the discretion of the district director. If the property purchased for the United States consists of bonds or other securities of the Federal Government, these securities should not be sold but must be transmitted to the Commissioner of Internal Revenue for proper disposition immediately after they have been purchased for the United States.

(2) Ordinarily the resale of personal property so purchased for the United States should be advertised merely by public posting, that is, by display of notice at the district director's office, at the

postoffice nearest the place where the resale is to take place, and at the place of resale. If the property is purchased for the United States at a price considerably less than its real market value, the district director may in his discretion insert an advertisement of resale in a newspaper. The selection of the place for such resale rests with the district director. If the place selected by the district director for resale is outside of the internal revenue district where the property was seized the approval of the Commissioner of Internal Revenue must first be obtained. In making the request for the Commissioner's approval in such case the district director should state, with full details, the reasons for his request, and the procedure he expects to follow if the approval of the Commissioner be obtained. If it appears for the best interests of the United States, the Commissioner may approve the selection of the place for resale, but may alter or modify the proposed procedure.

§ 39.3696–3697 *Statutory provisions; redemption of property; certificates of sale.*

SEC. 3696. *Redemption of property.* In any case of distraint for the payment of taxes, the goods, chattels, or effects so distrained shall be restored to the owner or possessor, if, prior to the sale, payment of the amount due is made to the proper officer charged with the collection, together with the fees and other charges; but in case of nonpayment, the said officer shall proceed to sell the said goods, chattels, or effects at public auction.

SEC. 3697. *Certificates of sale.* In all cases of sale, as aforesaid, the certificate of such sale—

(a) *As evidence.* Shall be prima facie evidence of the right of the officer to make such sale, and conclusive evidence of the regularity of his proceedings in making the sale; and

(b) *As conveyances.* Shall transfer to the purchaser all right, title, and interest of such delinquent in and to the property sold; and

(c) *As authority for transfer of corporate stock.* Where such property consists of stocks, shall be notice, when received, to any corporation, company, or association of said transfer, and shall be authority to such corporation, company, or association to record the transfer on their books and records in the same manner as if the stocks were transferred or assigned by the party holding the same, in lieu of any original or prior certificates, which shall be void, whether canceled or not; and

(d) *As receipts.* Where the subject of sale is securities or other evidences of debt, shall be a good and valid receipt to the person holding the same, as against any person holding, or claiming to hold, possession of such securities or other evidences of debt.

§ 39.3700–3706 *Statutory provisions; authority to distrain real estate; proceedings on distraint; redemption of real estate; certificates of purchase; deeds of sale; transmission of certificates and deeds to Commissioner; records of sale.*

SEC. 3700. *Authority to distrain.* When goods, chattels, or effects sufficient to satisfy the taxes imposed upon any person are not found by the collector or deputy collector, he is authorized to collect the same by seizure and sale of real estate.

SEC. 3701. *Proceedings on distraint*—(a) *Notice to owner.* The officer making the seizure mentioned in the preceding section shall give notice to the person whose estate it is proposed to sell by giving him in hand, or leaving at his last or usual place of abode, if he has any such within the collection district where said estate is situated, a notice, in writing, stating what particular estate is to be sold, describing the same with reasonable certainty, and the time when and place where said officer proposes to sell the same.

(b) *Public notice.* The said officer shall also cause a notification to the same effect to be published in some newspaper within the county where such seizure is made, if any such there be, and shall also cause a like notice to be posted at the post office nearest to the estate seized, and in two other public places within the county.

(c) *Time and place of sale.* The time of sale shall not be less than twenty nor more than forty days from the time of giving said notice. The place of said sale shall not be more than five miles distant from the estate seized, except by special order of the Commissioner.

(d) *Manner of sale.* At the time and place appointed, the officer making such seizure shall proceed to sell the said estate at public auction, offering the same at a minimum price, including the expense of making such levy, and all charges for advertising. When the real estate so seized consists of several distinct tracts or parcels, the officer making sale thereof shall offer each tract or parcel for sale separately, and shall, if he deem it advisable, apportion the expenses and charges aforesaid to such several tracts or parcels, or to any of them, in estimating the minimum price.

(e) *Purchasers.* If no person offers for said estate the amount of said minimum price, the officer shall declare the same to be purchased by him for the United States; otherwise the same shall be declared to be sold to the highest bidder.

(f) *Adjournment of sale.* The said sale may be adjourned from time to time by said officer for not exceeding thirty days in all, if he shall think it advisable so to do. If the amount bid shall not be then and there paid, the officer shall forthwith proceed to again sell said estate in the same manner.

SEC. 3702. *Redemption of real estate*—(a) *Before sale.* Any person whose estate may be proceeded against as aforesaid shall have the right to pay the amount due, together with the costs and charges thereon, to the collector or deputy collector at any time prior to the sale thereof, and all further proceedings shall cease from the time of such payment.

(b) *After sale*—(1) *Period.* The owners of any real estate sold as aforesaid, their heirs, executors, or administrators, or any person having any interest therein, or a lien thereon, or any person in their behalf, shall be permitted to redeem the land sold, or any particular tract thereof, at any time within one year after the sale thereof.

(2) *Price.* The land or tract aforesaid shall be permitted to be redeemed upon payment to the purchaser, or in case he can not be found in the county in which the land to be redeemed is situated, then to the collector of the district in which the land is situated, for the use of the purchaser, his heirs, or assigns, the amount paid by the said purchaser and interest thereon at the rate of 20 per centum per annum.

(c) *Record.* When any lands sold are redeemed as provided in this section, the collector shall make entry of the fact upon the record mentioned in section 3706, and the said entry shall be evidence of such redemption.

SEC. 3703. *Certificates of purchase*—(a) *Real estate purchased by the United States.* In case the real estate sold under section 3701 shall be declared to be purchased for the United States, the officer shall immediately transmit a certificate of the purchase to the Commissioner.

(b) *Real estate purchased by others.* Upon any sale of real estate, as provided in section 3701, and the payment of the purchase money, the officer making the seizure and sale shall give to the purchaser a certificate of purchase, which shall set forth the real estate purchased, for whose taxes the same was sold, the name of the purchaser, and the price paid therefor.

SEC. 3704. *Deeds of sale*—(a) *Real estate purchased by the United States.* In case real estate shall be declared under section 3701 (e) to be purchased for the United States, the officer shall—

(1) *Execution.* At the proper time, as provided in subsection (b), execute a deed therefor after its preparation and the endorsement of approval as to its form by the United States district attorney for the district in which the property is situate, and

(2) *Record and transmission.* Without delay cause the same to be duly recorded in the proper registry of deeds, and immediately thereafter transmit such deed to the Commissioner.

(b) *Real estate purchased by others.* If the said real estate be not redeemed in the manner and within the time provided in section 3702, the said collector or deputy collector shall execute to the said purchaser, upon his surrender of said certificate, a deed of the real estate purchased by him as aforesaid, reciting the facts set forth in said certificate, and in accordance with the laws of the State in which such real estate is situate upon the subject of sales of real estate under execution.

(c) *Legal effect*—(1) *As evidence.* The deed of sale given in pursuance of this section shall be prima facie evidence of the facts therein stated; and

(2) *As conveyance of title.* If the proceedings of the officer as set forth have been substantially in accordance with the provisions of law, such deed shall be considered and operate as a conveyance of all the right, title, and interest the party delinquent had in and to the real estate thus sold at the time the lien of the United States attached thereto.

SEC. 3705. *Transmission of certificates and deeds to Commissioner.* All certificates of purchase, and deeds of property purchased by the United States under the internal revenue laws, on sales for taxes, or under executions issued from United States courts, which may be found in the office of any collector, shall be immediately transmitted by such officer to the Commissioner.

SEC. 3706. *Records of sale*—(a) *Requirement.* It shall be the duty of every collector to keep a record of all sales of land made in his collection district, whether by himself or his deputies, or by another collector. And it shall be the duty of every deputy making sale, as aforesaid, to return a statement of all his proceedings to the collector, and to certify the record thereof.

(b) *Contents.* The record shall set forth the tax for which any such sale was made, the dates of seizure and sale, the name of the party assessed and all proceedings in making said sale, the amount of fees and expenses, the name of the purchaser, and the date of the deed.

(c) *Certification.* The said record shall be certified by the officer making the sale.

(d) *Copy to Commissioner.* On or before the 5th day of each succeeding month, the collector shall transmit a copy of such record of the preceding month to the Commissioner.

(e) *Delivery by collector to successor.* In case of the death or removal of the collector, or the expiration of his term of office from any other cause, said record shall be delivered to his successor in office.

(f) *Copy as evidence.* A copy of every such record, certified by the collector, shall be evidence in any court of the truth of the facts therein stated.

§ 39.3710–3716 *Statutory provisions; surrender of property subject to distraint; production of books; sale of indivisible property; distraint by district director outside his district; period of limitation upon distraint; successive seizures; fees and charges in distraint and seizure cases.*

SEC. 3710. *Surrender of property subject to distraint*—(a) *Requirement.* Any person in possession of property, or rights to property, subject to distraint, upon which a levy has been made, shall, upon demand by the collector or deputy collector making such levy, surrender such property or rights to such collector or deputy, unless such property or right is, at the time of such demand, subject to an attachment or execution under any judicial process.

(b) *Penalty for violation.* Any person who fails or refuses to so surrender any of such property or rights shall be liable in his own person and estate to the United States in a sum equal to the value of the property or rights not so surrendered, but not exceeding the amount of the taxes (including penalties and interest) for the collection of which such levy has been made, together with costs and interest from the date of such levy.

(c) *Person defined.* 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.

SEC. 3711. *Production of books.* All persons, and officers of companies or corporations, are required, on demand of a collector or deputy collector about to distrain or having distrained on any property, or rights of property, to exhibit all books containing evidence or statements relating to the subject of distraint, or the property or rights of property liable to distraint for the tax due.

SEC. 3712. *Sale of indivisible property.* When any property liable to distraint for taxes is not divisible, so as to enable the collector by sale of a part thereof to raise the whole amount of the tax, with all costs and charges, the whole of such property shall be sold, and the surplus of the proceeds of the sale, after making allowance for the amount of the tax, interest, penalties, and additions thereto, and for the costs and charges of the distraint and sale, shall be deposited with the Treasurer of the United States as provided in section 3971.

SEC. 3713. *Distraint by collector outside his district.* Any collector or deputy collector may, for the collection of taxes imposed upon any person, and committed to him for collection, seize and sell any of the property, real or personal (except property exempt from distraint and sale under section 3691), or any right or interest therein, of such person situated in any other collection district within the State in which such officer resides, notwithstanding the provisions of subsection (b) of section 3651; and his proceedings in relation thereto shall have the same effect as if the same were had in his proper collection district.

SEC. 3714. *Period of limitation upon distraint*—(a) *Length of period.* For period within which distraint may be begun in case of—

Income tax, see sections 276 (c) and 277.

* * * * *

(b) *Date of beginning distraint.* In determining the running of any period of limitation in respect of distraint, the distraint shall be held to have been begun—

(1) *Personal property.* In the case of personal property, on the date on which the levy upon such property is made; or

(2) *Real property.* 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.

[Sec. 3714 as amended by sec. 207 (b) (4), Social Security Act Amendment 1950]

SEC. 3715. *Successive seizures.* Whenever any property, personal or real, which is seized and sold by virtue of the foregoing provisions, is not sufficient to satisfy the claim of the United States for which distraint or seizure is made, the collector may, thereafter, and as often as the same may be necessary, proceed to seize and sell in like manner, any other property liable to seizure of the person against whom such claim exists, until the amount due from him, together with all expenses, is fully paid.

SEC. 3716. *Fees and charges in distraint and seizure cases.* The Commissioner shall by regulation determine the fees and charges to be allowed in all cases of distraint and other seizures; and shall have power to determine whether any expense incurred in making any distraint or seizure was necessary.

§ 39.3725 *Statutory provisions; stamping, marking, and branding seized goods.*

SEC. 3725. *Stamping, marking, and branding seized goods.* Where any whisky or tobacco, or other article of manufacture or produce, requiring brands, stamps, or marks of whatever kind to be placed thereon shall be sold upon distraint, forfeiture (except as provided in section 2805 with respect to distilled spirits), or other process provided by law, the same not having been branded, stamped, or marked, as required by law, the officer selling the same shall, upon sale thereof, fix or cause to be affixed the brands, stamps, or marks, so required.

SUITS BY UNITED STATES

§ 39.3740 *Statutory provisions; authorization to commence suit.*

SEC. 3740. *Authorization to commence suit.* No suit for the recovery of taxes, or of any fine, penalty, or forfeiture, shall be commenced unless the Commissioner authorizes or sanctions the proceedings and the Attorney General directs that the suit be commenced.

§ 39.3743 *Statutory provisions; authorization for regulations.*

SEC. 3743. *Regulations.* It shall be the duty of the Commissioner, with the approval of the Secretary, to establish such regulations, not inconsistent with law, for the observance of revenue officers, respecting suits arising under the internal revenue laws in which the United States is a party, as may be deemed necessary for the just responsibility of those officers and the prompt collection of all revenues and debts due and accruing to the United States under such laws.

§ 39.3745–3748 *Statutory provisions; district director's report to district attorney of willful violation of law; suits for recovery of erroneous refunds; disposition of judgments and moneys recovered, periods of limitation.*

SEC. 3745. *Suits for fines, penalties, and forfeitures*—(a) *Collector's reports to district attorney.* It shall be the duty of every collector of internal revenue having knowledge of any willful violation of any law of the United States relating to the revenue, within thirty days after coming into possession of such knowledge, to file with the district attorney of the district in which any fine, penalty, or forfeiture may be incurred, a statement of all the facts and circumstances of the case within his knowledge, together with the names of the witnesses, setting forth the provisions of law believed to be so violated on which reliance may be had for condemnation or conviction.

[Sec. 3745 as amended by sec. 142, Pub. Law 72 (81st Cong.)]

SEC. 3746. *Suits for recovery of erroneous refunds*—(a) *Refunds after limitation period.* Any portion of an internal revenue tax (or any interest, penalty, additional amount, or addition to such tax) refund of which is erroneously made, within the meaning of section 3774, may be recovered by suit brought in the name of the United States, but only if such suit is begun within two years after the making of such refund.

(b) *Refunds otherwise erroneous.* Any portion of an internal revenue tax (or any interest, penalty, additional amount, or addition to such tax) which has been erroneously refunded (if such refund would not be considered as erroneous under section 3774) may be recovered by suit brought in the name of the United States, but only if such suit is begun before the expiration of two years after the making of such refund.

(c) *Refunds based on fraud or misrepresentation.* Despite the provisions of subsections (a) and (b) such suit may be brought at any time within five years from the making of the refund if it appears that any part of the refund was induced by fraud or the misrepresentation of a material fact.

(d) *Interest.* Erroneous refunds recoverable by suit under this section shall bear interest at the rate of 6 per centum per annum from the date of the payment of the refund.

SEC. 3747. *Disposition of judgments and moneys recovered.* All judgments and moneys recovered or received for taxes, costs, forfeitures, and penalties, shall be paid to collectors as internal revenue taxes are required to be paid.

SEC. 3748. *Periods of limitation*—(a) *Criminal prosecutions.* No person shall be prosecuted, tried, or punished, for any of the various offences arising under the internal revenue laws of the United States unless the indictment is found or the information instituted within three years next after the commission of the offense, except that the period of limitation shall be six years—

(1) For offenses involving the defrauding or attempting to defraud the United States or any agency thereof, whether by conspiracy or not, and in any manner,

(2) For the offense of willfully attempting in any manner to evade or defeat any tax or the payment thereof, and

(3) For the offense of willfully aiding or assisting in, or procuring, counseling, or advising, the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a false or fraudulent return, affidavit, claim, or document (whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document).

For offenses arising under section 37 of the Criminal Code, March 4, 1909, 35 Stat. 1096 (U. S. C. Title 18, sec. 88 [now sec. 371]) where the object of the conspiracy is to attempt in any manner to evade or defeat any tax or the payment thereof, the period of limitation shall also be six years. The time during

which the person committing any of the offenses above mentioned is absent from the district wherein the same is committed shall not be taken as any part of the time limited by law for the commencement of such proceedings. Where a complaint is instituted before a commissioner of the United States within the period above limited, the time shall be extended until the discharge of the grand jury at its next session within the district.

(b) *Scope of limitations.* Subsection (a) of this section shall apply to offenses whenever committed; except that it shall not apply to offenses the prosecution of which was barred before June 6, 1932.

(c) *Civil suits.* For period of limitation in respect of—

Suits for fines, penalties, and forfeitures, see section 1047 of the Revised Statutes (U. S. C., Title 28, sec. 791 [now sec. 2462]).

Suits for erroneous refunds, see section 3746.

CLOSING AGREEMENTS AND COMPROMISES

§ 39.3760 *Statutory provisions; closing agreements.*

SEC. 3760. *Closing agreements*—(a) *Authorization.* The Commissioner (or any officer or employee of the Bureau of Internal Revenue, including the field service, authorized in writing by the Commissioner) is authorized to enter into an agreement in writing with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period.

(b) *Finality.* If such agreement is approved by the Secretary, the Under Secretary, or an Assistant Secretary, within such time as may be stated in such agreement, or later agreed to, such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact—

(1) The case shall not be reopened as to the matters agreed upon or the agreement modified, by any officer, employee, or agent of the United States, and

(2) In any suit, action, or proceeding, such agreement, or any determination, assessment, collection, payment, abatement, refund, or credit made in accordance therewith, shall not be annulled, modified, set aside, or disregarded.

§ 39.3760-1 *Closing agreements relating to tax liability in respect of internal revenue taxes.* (a) Closing agreements provided for in section 3760 of the Internal Revenue Code may relate to any taxable period ending prior or subsequent to the date of the agreement. With respect to taxable periods ending prior to the date of the agreement, the matter agreed upon may relate to the total tax liability of the taxpayer or it may relate to one or more separate items affecting the tax liability of the taxpayer, as for example, the amount of gross income, deductions for losses, depreciation or depletion, or the year for which an item of income is to be included in gross income or the year for which an item of loss is to be deducted, or the value of property on a specified date. A closing agreement may also be entered into in order to provide a "determination under the income tax laws" as defined in section 3801 (a) (1) (A) of the Internal Revenue Code. With respect to taxable periods ending subsequent to the date of the agreement, the matter agreed upon may relate only to one or more separate items affecting the tax liability of the taxpayer. The following, among others, are examples of the latter type of closing agreement: (1) A taxpayer may sell a portion of his holdings in a particular stock. A closing agreement may be entered into fixing the cost or other legal factor determining the basis for computing gain or loss on such sale, and, at the same time fixing the cost or other legal factor determining the basis (unless or until the statute is changed to require the use of some other factor to determine basis) of the remaining portion of the stock still held by the taxpayer upon which gain or loss will be computed when the taxpayer sells such stock in a later year; (2) if the taxpayer is undecided whether to sell property or hold it, or as to the price at which to sell it, a closing agreement may be entered into determining the market value of the property as of March 1, 1913, for future taxable periods, prior to the consummation of the sale by the taxpayer. A closing agreement with respect to any taxable period ending subsequent to the date of the agreement is subject to any change in or modification of the law enacted subsequent to the date of the agreement and applicable to such taxable period, and each closing agreement shall so recite. Closing agreements may be executed even though under the agreement the taxpayer is not liable for any tax for the period to which the agreement relates. There may be a series of agreements relating to the tax liability for a single period. Any tax or deficiency in tax determined pursuant to a closing agreement shall be assessed and collected, and any overpayment determined pursuant thereto shall be credited or refunded in accordance with the applicable provisions of law.

(b) The procedure in the Internal Revenue Service with respect to applications for entering into closing agreements in accordance with the regulations under section 3760 will be under such rules as may be prescribed from time to time by the Commissioner.

§ 39.3761-3762 *Statutory provisions; compromises; penalties for concealment of property or withholding, etc., of records.*

SEC. 3761. *Compromises*—(a) *Authorization.* The Commissioner, with the approval of the Secretary, or of the Under Secretary of the Treasury, or of an Assistant Secretary of the Treasury, may compromise any civil or criminal case arising under the internal revenue laws prior to reference to the Department of Justice for prosecution or defense; and the Attorney General may compromise any such case after reference to the Department of Justice for prosecution or defense.

(b) *Record.* Whenever a compromise is made by the Commissioner in any case there shall be placed on file in the office of the Commissioner the opinion of the General Counsel for the Department of the Treasury, or of the officer acting as such, with his reasons therefor, with a statement of—

(1) The amount of tax assessed,

(2) The amount of additional tax or penalty imposed by law in consequence of the neglect or delinquency of the person against whom the tax is assessed, and

(3) The amount actually paid in accordance with the terms of the compromise.

(c) *Cross reference.* For compromises after judgment, see R. S. sec. 3469 (U. S. C., Title 31, sec. 194).

SEC. 3762. *Penalties.* Any person who, in connection with any compromise under section 3761, or offer of such compromise, or in connection with any closing agreement under section 3760, or offer to enter into any such agreement, willfully—

(a) *Concealment of property.* Conceals from any officer or employee of the United States any property belonging to the estate of a taxpayer or other person liable in respect of the tax, or

(b) *Withholding, falsifying, and destroying records.* Receives, destroys, mutilates, or falsifies any book, document, or record, or makes under oath any false statement, relating to the estate or financial condition of the taxpayer or other person liable in respect of the tax—

Shall, upon conviction thereof, be fined not more than $10,000 or imprisoned for not more than one year, or both.

ABATEMENTS, CREDITS, AND REFUNDS

§ 39.3770-3775 *Statutory provisions; authority to make abatements, credits, and refunds; interest on overpayments; suits for refund, interest on judgments; refunds after periods of limitation, credits after periods of limitation.*

SEC. 3770. *Authority to make abatements, credits, and refunds*—(a) *To taxpayers*—(1) *Assessments and collections generally.* Except as otherwise provided by law in the case of income war-profits, excess-profits, estate, and gift taxes, the Commissioner, subject to regulations prescribed by the Secretary, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected.

(2) *Assessments and collections after limitation period.* Any tax (or any interest, penalty, additional amount, or addition to such tax) assessed or paid after the expiration of the period of limitation properly applicable thereto shall be considered an overpayment and shall be credited or refunded to the taxpayer if claim therefor is filed within the period of limitation for filing such claim.

(3) *Date of allowance.* Where the Commissioner has signed a schedule of overassessments in respect of any internal revenue tax imposed by this title, the Revenue Act of 1932, or any prior revenue Act, the date on which he first signed such schedule (if after May 28, 1928) shall be considered as the date of allowance of refund or credit in respect of such tax.

(4) *Credit of overpayment of one class of tax against another class of tax due.* Notwithstanding any provision of law to the contrary, the Commissioner may, in his discretion, in lieu of refunding an overpayment of tax imposed by any provision of this title, credit such overpayment against any tax due from the taxpayer under any other provision of this title.

(5) *Delegation of authority to collectors to make refunds.* The Commissioner, with the approval of the Secretary, is authorized to delegate to collectors any authority, duty, or function which the Commissioner is authorized or required to exercise or perform under paragraph (1), (2), (3), or (4) of this subsection, or under section 322 or 1027, where the amount involved (exclusive of interest, penalties, additions to the tax, and additional amounts) does not exceed $10,000.

(6) *Cross references.* For limitations on refunds and credits in case of—

Income tax, see section 322.

* * * * *

(b) *To collectors and officers.* The Commissioner, subject to regulations prescribed by the Secretary, is authorized to repay—

(1) *Collections recovered.* To any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal revenue taxes collected by him, with the cost and expense of suit; also

(2) *Damages and costs.* All damages and costs recovered against any collector, deputy collector, agent, or inspector, in any suit brought against him by reason of anything done in the due performance of his official duty.

(c) *Rule where no tax liability.* An amount paid as tax shall not be considered not to constitute an overpayment solely by reason of the fact that there was no tax liability in respect of which such amount was paid.

[Sec. 3770 as amended by sec. 508 (b), Second Rev. Act 1940; sec. 4 (c) and (d) Current Tax Payment Act 1943; sec. 9 (a), Pub. Law 271 (81st Cong.); sec. 207 (b) (5), Social Security Act Amendments 1950]

SEC. 3771. *Interest on overpayments*—(a) *Rate.* Interest shall be allowed and paid upon any overpayment in respect of any internal revenue tax at the rate of 6 per centum per annum.

(b) *Period.* Such interest shall be allowed and paid as follows:

(1) *Credits.* In the case of a credit, from the date of the overpayment to the due date of the amount against which the credit is taken, but if the amount against which the credit is taken is an additional assessment of a tax imposed by the Revenue Act of 1921, 42 Stat. 227, or any subsequent Revenue Act, then to the date of the assessment of that amount.

(2) *Refunds.* In the case of a refund, from the date of the overpayment to a date preceding the date of the refund check by not more than thirty days, such date to be determined by the Commissioner, whether or nor such refund check is accepted by the taxpayer after tender of such check to the taxpayer. The acceptance of such check shall be without prejudice to any right of the taxpayer to claim any additional overpayment and interest thereon.

(c) *Additional assessment defined.* As used in this section the term "additional assessment" means a further assessment for a tax of the same character previously paid in part, and includes the assessment of a deficiency of any income or estate tax imposed by the Revenue Act of 1924, 43 Stat. 253, or by any subsequent Revenue Act.

(d) *Claims based on deduction for bad debts or worthless securities.* If credit or refund of any part of an overpayment would be barred under section 322 (b), except for paragraph (5) thereof, or under section 322 (d), except for clause (2) thereof, no interest shall be allowed or paid with respect to such part of the overpayment for any period beginning after the expiration of the period of limitation provided in section 322 (b) (1) for filing claim for credit refund of such part of the overpayment and ending at the expiration of six months after the date on which the claim was filed or, in case no claim was filed and the overpayment was found by the Board, ending at the time the petition was filed with the Board.

(e) *Claims based on carry-back of loss or credit.* If the Commissioner determines that any part of an overpayment is attributable to the inclusion in computing the net operating loss deduction for the taxable year of any part of the net operating loss for a succeeding taxable year or to the inclusion in computing the unused excess profits credit adjustment for the taxable year of any part of the unused excess profits credit for a succeeding taxable year, no interest shall be allowed or paid with respect to such part of the overpayment for any period before the filing of a claim for credit or refund of such part of the overpayment or the filing of a petition with the Board, whichever is earlier; nor for any period beginning with the date of filing of an application under section 3780 (a) relating to such part of the overpayment and ending with the last date the Commissioner's determination is required to be made under section 3780 (b); nor, in case an application is made under section 3780 (a), for any period before the first day of the month immediately following the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for filing the return for the taxable year of the net operating loss or unused excess profits credit, or before the date on which the return is filed, whichever is later.

(f) *Estimated tax and tax withheld at source.* For date of payment in respect of estimated tax and of tax withheld at source on wages, see section 322 (e).

(g) *Claims based upon relief under section 722.* * * * [No longer applicable.]

[Sec. 3771 as amended by secs. 124 (c), 153 (d), 172 (f) (5), Rev. Act 1942; sec. 4 (e), Current Tax Payment Act 1943; sec. 2 (b), Pub. Law 201 (78th Cong.); sec. 6 (b), Tax Adjustment Act 1945]

SEC. 3772. *Suits for refund*—(a) *Limitations*—(1) *Claim.* No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected until a claim for refund or credit has been duly filed with the Commissioner, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.

(2) *Time.* No such suit or proceeding shall be begun before the expiration of six months from the date of filing such claim unless the Commissioner renders a decision thereon within that time, nor after the expiration of two years from the date of mailing by registered mail by the Commissioner to the taxpayer of a notice of the disallowance of the part of the claim to which such suit or proceeding relates.

(3) *Reconsideration after mailing of notice.* Any consideration, reconsideration, or action by the Commissioner with respect to such claim following the mailing of a notice by registered mail of disallowance shall not operate to extend the period within which suit may be begun. This paragraph shall not operate (A) to bar a suit or proceeding in respect of a claim reopened prior to June 22, 1936, if such suit or proceeding was not barred under the law in effect prior to that date, or (B) to prevent the suspension of the statute of limitations for filing suit under section 3774 (b) (2).

(b) *Protests or duress.* Such suit or proceeding may be maintained, whether or not such tax, penalty, or sum has been paid under protest or duress.

(c) *Cross references.* For provisions relating to claims for refund or credit filed with the Commissioner in respect of—

Income tax, see section 322. * * *

(d) *Suits against collector a bar.* A suit against a collector (or former collector) or his personal representative for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected shall be treated as if the United States had been a party to such suit in applying the doctrine of res judicata in all suits instituted after June 15, 1942, in respect of any internal revenue tax, and in all proceedings in the Board and on review of decisions of the Board where the petition to the Board was filed after such date.

(e) *Credit treated as payment.* The credit of an overpayment of any tax in satisfaction of any tax liability shall, for the purpose of any suit for refund of such tax liability so satisfied, be deemed to be a payment in respect of such tax liability to the collector in office at the time such credit is allowed.

[Sec. 3772 as amended by sec. 503, Rev. Act 1942; sec. 9 (b), Pub. Law 271 (81st Cong.); sec. 207 (b) (6), Social Security Act Amendments 1950]

SEC. 3773. *Interest on judgments.* For interest on judgments, see section 177 of the Judicial Code as amended by act of May 29, 1928, c. 852, section 615, 45 Stat. 877 (U. S. C., Title 28, section 284 [now sec. 2516 (a)]).

SEC. 3774. *Refunds after periods of limitation.* A refund of any portion of an internal revenue tax (or any interest, penalty, additional amount, or addition to such tax) shall be considered erroneous—

(a) *Expiration of period for filing claim.* If made after the expiration of the period of limitation for filing claim therefor, unless within such period claim was filed; or

(b) *Disallowance of claim and expiration of period for filing suit.* In the case of a claim filed within the proper time and disallowed by the Commissioner if the refund was made after the expiration of the period of limitation for filing suits, unless—

(1) Within such period suit was begun by the taxpayer, or

(2) Within such period, the taxpayer and the Commissioner agreed in writing to suspend the running of the statute of limitations for filing suit from the date of the agreement to the date of final decision in one or more named cases then pending before the Board of Tax Appeals or the courts. If such agreement has been entered into, the running of such statute of limitations shall be suspended in accordance with the terms of the agreement.

(c) *Cross reference.* For procedure by the United States to recover erroneous refunds, see section 3746.

SEC. 3775. *Credits after periods of limitation*—(a) *Period against United States.* Any credit against a liability in respect of any taxable year shall be void if any payment in respect of such liability would be considered an overpayment under section 3770 (a) (2).

(b) *Period against taxpayer.* A credit of an overpayment in respect of any tax shall be void if a refund of such overpayment would be considered erroneous under section 3774.

§ 39.3777 *Statutory provisions; reports of refunds and credits in excess of $200,000.*

SEC. 3777. *Reports of refunds and credits in excess of $200,000*—(a) *By Commissioner to Joint Committee.* No refund or credit of any income, war-profits, excess-profits, estate, or gift tax in excess of $200,000 shall be made until after the expiration of thirty days from the date upon which a report giving the name of the person to whom the refund or credit is to be made, the amount of such refund or credit, and a summary of the facts and the decision of the Commissioner is submitted to the Joint Committee on Internal Revenue Taxation.

(b) *By Joint Committee to Congress.* A report to Congress shall be made annually by such committee of such refunds and credits, including the names of all persons and cor-

porations to whom amounts are credited or payments are made, together with the amounts credited or paid to each.

(c) *Tentative adjustments.* Any credit or refund allowed or made under section 3780 (b) or under section 124 (k) shall be made without regard to the provisions of subsection (a). In any such case, if the credit or refund, reduced by any deficiency in such tax thereafter assessed and by deficiencies in any other tax resulting from adjustments reflected in the determination of the credit or refund, is in excess of $200,000, there shall be submitted to such committee a report containing the matter specified in subsection (a) at such time after the making of the credit or refund as the Commissioner shall determine the correct amount of the tax.

[Sec. 3777 as amended by sec. 4 (c), Tax Adjustment Act 1945; sec. 151, Rev. Act 1945; sec. 10 (b), Pub. Law 271 (81st Cong.)]

§ 39.3779 *Statutory provisions; extensions of time for payment of taxes by corporations expecting carry-backs.*

SEC. 3779. *Extensions of time for payment of taxes by corporations expecting carry-backs*—(a) *In general.* If a corporation, in any taxable year ending on or after September 30, 1945, files with the collector a statement, as provided in subsection (b), with respect to an expected net operating loss carry-back or unused excess profits credit carry-back from such taxable year, the time for payment of all or part of any tax imposed by chapter 1 or 2 for the taxable year immediately preceding such taxable year shall be extended, to the extent and subject to the conditions and limitations hereinafter provided in this section.

(b) *Contents of statement.* The statement with respect to an expected carry-back referred to in subsection (a) of this section shall be sworn to in the manner prescribed by section 52 in the case of a return and shall be filed at such time and in such manner and form as the Commissioner, with the approval of the Secretary, may by regulations prescribe. Such statement shall set forth that the corporation expects to have a net operating loss carry-back, as provided in section 122 (b), or an unused excess profits credit carry-back, as provided in section 432 (c), from the taxable year in which such statement is made, and shall set forth, in such detail and with such supporting data and explanation as such regulations shall require—

(1) The estimated amount of the expected net operating loss or unused excess profits credit;

(2) The reasons, facts, and circumstances which cause the corporation to expect such net operating loss or unused excess profits credit;

(3) The amount of the reduction, attributable to the expected carry-back, in the aggregate of the taxes previously determined for all taxable years affected by the carry-back prior to the taxable year of the expected loss or unused credit; such taxes previously determined being ascertained in accordance with the method prescribed in section 3801 (d) and such reduction being determined by applying the expected carry-back in the manner provided by law to the items on the basis of which such taxes were determined but such reduction being decreased by the amount of any credits under section 780 properly allocable to such reduction;

(4) The tax or taxes and the amount thereof the time for payment of which is to be extended; and

(5) Such other information for the purpose of carrying out the provisions of this section as may be required by such regulations.

The collector shall, upon request, furnish a receipt for any statement filed, which shall set forth the date of such filing.

(c) *Amount to which extension relates and installment payments.* The amount the time for payment of which may be extended under subsection (a) with respect to any tax shall not exceed the amount of such tax shown on the return, increased by any amount assessed as a deficiency (or as interest or additions to the tax) prior to the date of filing the statement and decreased by any amount paid or required to be paid prior to the date of such filing, and the total amount of the taxes the time for payment of which may be extended shall not exceed the amount stated under clause (3) of subsection (b). For the purposes of this subsection, an amount shall not be considered as required to be paid unless shown on the return or assessed as a deficiency (or as interest or additions to the tax), and an amount assessed as a deficiency (or as interest or addition to the tax) shall be considered to be required to be paid prior to the date of filing of the statement if the tenth day after notice and demand for its payment occurs prior to such date. If an extension of time under this section relates to only a part of a tax, the time for payment of the remainder shall be considered to be the dates on which payments would have been required if such remainder had been the tax and the taxpayer had elected to pay the tax in installments as provided in section 56 (b).

(d) *Period of extension.* The extension of time for payment provided in this section shall expire—

(1) On the last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for the filing of the return for the taxable year of the expected net operating loss or unused excess profits credit, or

(2) If an application for tentative carry-back adjustment provided in section 3780 with respect to such loss or unused credit is filed before the expiration of the period prescribed in clause (1), on the date on which notice is mailed by registered mail by the Commissioner to the taxpayer that such application is allowed or disallowed in whole or in part.

(e) *Revised statements.* Each statement filed under subsection (a) with respect to any taxable year shall be in lieu of the last statement previously filed with respect to such year. If the amount the time for payment of which is extended under a statement filed is less than the amount under the last statement previously filed the extension of time shall be terminated as to the difference between the two amounts.

(f) *Termination by Commissioner.* The Commissioner is not required to make any examination of the statement, but he may make such examination thereof as he deems necessary and practicable. The Commissioner shall terminate the extension as to any part of the amount to which it relates which he deems should be terminated because, upon such examination, he believes that, as of the time such examination is made, all or any part of the statement clearly is in a material respect erroneous or unreasonable.

(g) *Payments on termination.* If an extension of time is terminated under subsection (e) or (f) with respect to any amount, then—

(1) No further extension of time shall be made under this section with respect to such amount, and

(2) The time for payment of such amount shall be considered to be the dates on which payments would have been required if there had been no extension with respect to such amount and the taxpayer had elected to pay the tax in installments as provided in section 56 (b).

(h) *Jeopardy.* If the Commissioner believes that collection of the amount to which an extension under this section relates is in jeopardy, he shall immediately terminate such extension and notice and demand shall be made by the collector for payment of such amount.

(i) *Interest.* In the case of an amount the time for payment of which has been extended, there shall be collected as part of such amount interest from the dates on which payments would have been required if there had been no extension and the taxpayer had elected to pay the tax in installments as provided in section 56 (b)—

(1) Upon so much of such amount as is satisfied under section 3780 (b) by applying or crediting thereto, within the period of extension, a decrease in tax determined in connection with an application under section 3780 (a), interest at the rate of 3 per centum per annum to the date of such satisfaction, except that on so much of such satisfied amount as is not in excess of the amount of the deficiencies assessed under section 3780 (b) and which is not so satisfied, the rate shall be 6 per centum per annum; and

(2) Upon the remainder of the amount the time for payment of which has been extended, interest at the rate of 6 per centum per annum to the date such amount is paid.

If the Commissioner determines that during the period of extension credit or refund of an overpayment has been allowed or made, or a deficiency assessed, affecting the amount to which the extension relates and that the taxpayer could not have taken such overpayment or deficiency into account in the statement or a revised statement, appropriate adjustment shall be made in the interest.

[Sec. 3779 as added by sec. 4 (a), Tax Adjustment Act 1945; amended by sec. 304 (a), Excess Profits Tax Act 1950]

§ 39.3779-1 *Extensions of time for payment of taxes by corporations expecting carry-backs.* (a) If a corporation files a statement with respect to an expected net operating loss carry-back or unused excess profits credit carry-back from any taxable year, such corporation may extend the time for the payment of all or any part of certain taxes to the extent and subject to the limitations provided in section 3779. A corporation may extend the time for payment with respect to only such taxes as meet the following four requirements:

(1) The tax must be one imposed by chapter 1 or chapter 2;

(2) The tax must be for the taxable year immediately preceding the taxable year of the expected net operating loss or unused excess profits credit;

(3) The tax must be shown on the return or must be assessed within the taxable year of the expected net operating loss or unused excess profits credit; and

(4) The tax must not have been paid or required to have been paid prior to the filing of the statement.

(b) The time for payment of the tax is automatically extended under section 3779 upon the filing of a statement by the corporation with the district director of internal revenue where the tax is payable with respect to the expected net operating loss carry-back or unused excess profits credit carry-back. The period of extension is that provided in section 3779 (d) unless sooner terminated by action of either the Commissioner or the corporation.

§ 39.3779-2 *Contents of statement.* (a) The statement with respect to an expected carry-back which must be filed by a corporation in order to extend the time for payment of tax under section 3779 is to be filed on Form 1138. The statement must be filled out in accordance with the instructions accompanying the form, and all information required by the form and the instructions must be furnished by the taxpayer. The statement shall contain or be verified by a written declaration that it is made under the penalties of perjury. The district director of internal revenue, upon request, will furnish a receipt for any statement filed. Such receipt will show the date the statement was filed.

(b) The reduction, attributable to the expected carry-back, in the aggregate of the taxes previously determined for all taxable years, affected by the carry-back, prior to the taxable year of the expected net operating loss or unused excess profits credit will be the excess of the decreases over the increases, attributable to the expected carry-back or any related adjustments, in such taxes as previously determined. The tax previously determined is to be ascertained in accordance with the method prescribed in section 3801 (d) In general, therefore, the tax previously determined will be the tax shown by the taxpayer on its return, increased by any amounts assessed (or collected without assessment) as deficiencies prior to the date of the filing of the statement, and decreased by any amounts abated, credited, refunded, or otherwise repaid prior to such date. Any items as to which the Commissioner and the taxpayer are in disagreement at the time of the filing of the statement shall be taken into account in ascertaining the tax previously determined only if, and to the extent that, they were reported in the return, or were reflected in any amounts assessed (or collected without assessment) as deficiencies, or in any amounts abated, credited, refunded, or otherwise repaid, prior to the date of the filing of the statement. The tax previously determined will reflect the foreign tax credit and the credit for tax withheld at source provided in section 32.

(c) The increase or decrease, attributable to the expected carry-back or any related adjustments, in any tax previously determined is to be ascertained, except for such carry-back and related adjustments, on the basis of the items which entered into the computation of such tax as previously determined. Accordingly, as in ascertaining the tax previously determined, items must be taken into account only to the extent that such items were included in the return, or were reflected in amounts assessed (or collected without assessment) as deficiencies, or in amounts abated, credited, refunded, or otherwise repaid, prior to the date of the filing of the statement. Thus, for example, if the taxpayer claimed a deduction for depreciation of $10,000 in its return and the Commissioner asserts that only $4,000 is properly deductible, no change is to be made in the $10,000 depreciation deduction as shown by the taxpayer on his return unless a deficiency has been assessed, or an amount collected without assessment, prior to the date of the filing of the statement as a result of a change in the depreciation deduction, or unless such change in the depreciation deduction was reflected in an amount abated, credited, refunded, or otherwise repaid prior to such date. In determining the increase or decrease in any tax previously determined, any items which are affected by the carry-back must be adjusted to reflect such carry-back. Thus, any deduction limited, for example, by net income, such as the deduction for charitable contributions, is to be recomputed on the basis of the net income as affected by the carry-back. Similarly, in any case where one tax is allowable as a deduction in computing a second tax, or where the income subject to one tax is a credit in computing the income subject to the second tax, such deduction or credit must be adjusted to reflect such carry-back. In determining the net operating loss deduction, the adjustments required by sections 122 (c) and 433 (a) (1) (J) are likewise to be made.

(d) The reduction in the aggregate of the taxes previously determined is a net reduction. That is, in determining such reduction, a decrease, attributable to a carry-back, in any one tax, e. g., the income tax, will be offset by an increase in any other tax, e. g., the surtax on personal holding companies, resulting from such decrease.

§ 39.3779-3 *Amount of tax the time for payment of which may be extended*—(a) *Total amount to which extension may relate.* The total amount of one or more taxes the time for payment of which may be extended under section 3779 may not exceed the amount shown in item 4 (c) of Form 1138.

(b) *Amount of any one tax to which extension may relate.* (1) The taxpayer is to specify in item 5 (j) of Form 1138 the tax or taxes and the amount thereof the time for payment of which is to be extended. In case of any one tax the amount to which an extension may relate may not exceed the amount of such tax shown on the return as filed, increased by any amount assessed as a deficiency (or as interest or additions to the tax) prior to the date of filing the statement and decreased by any amount paid or required to be paid prior to such date. In determining the amount of tax required to be paid prior to the date of filing the statement, only the following amounts shall be taken into consideration:

(i) The amount of the tax shown on the return as filed; and

(ii) Any amount assessed as a deficiency (or as interest or additions to the tax) if the tenth day after notice and demand for its payment occurs prior to the date of the filing of the statement.

(2) Delinquent installments are to be considered amounts required to be paid prior to the date of filing the statement. In the case of any authorized extension of time under section 56 (c), the amount of tax the time for payment of which is so extended is not to be considered required to be paid prior to the end of such extension. Similarly, any amount assessed as a deficiency (or as interest or additions to the tax) is not to be considered required to be paid prior to the date of the filing of the statement unless the tenth day after notice and demand for its payment falls prior to the date of the filing of the statement.

(3) The taxpayer may choose to extend the time for payment of all of one or more taxes, or it may choose to extend the time for payment of portions of several taxes. The taxes chosen by the taxpayer need not be those taxes which are affected by the carry-back. The amount to which an extension may relate in the case of any one tax may not exceed the amount specified in section 3779 (c) and shown in item 5 (i) of Form 1138, and the total amount of all taxes the time for payment of which may be extended may not exceed the amount specified in section 3779 (c) and shown in item 4 (c) of Form 1138. Such amounts represent the maximum amounts the time for payment of which may be extended; the amount the time for payment of which is extended in the case of any one tax, or the total of such amounts, may be less than the maximum amounts specified in section 3779 (c) and shown in items 5 (i) and 4 (c) respectively, of Form 1138.

§ 39.3779-4 *Payment of remainder of tax where extension relates to only part of the tax.* (a) If an extension of time relates to only part of the tax, the time for payment of the remainder of the tax shall be considered to be the dates on which payments would have been required if such remainder had been the tax and the taxpayer had elected to pay the tax in installments as provided in section 56 (b).

(b) The provisions of this section may be illustrated by the following example:

Example. Corporation A, which keeps its books and makes its tax returns on the calendar year basis, filed its income tax return for 1952 on March 15, 1953. The corporation showed a tax of $1,000 on its return and paid 40 percent of such tax, or $400, on March 15, 1953. On June 1, 1953, Corporation A, pursuant to the provisions of section 3779, extended the time for payment of $500 of such tax. The remainder of the tax the time for payment of which was not so extended, i. e., $500, is to be considered the tax for purposes of determining when it is to be paid. Such remainder is to be paid in installments on each of the normal installment dates. Since the taxable year is the calendar year 1952, 40 percent of $500 is due on each of the first two installment dates and 10 percent of $500 is due on each of the last two installment dates. Since the corporation has already paid $400 on March 15, 1953, it will have nothing to pay on June 15, 1953, and it will pay $50 on September 15, 1953, and $50 on December 15, 1953.

§ 39.3779-5 *Period of extension.* If the time for the payment of any tax has been extended pursuant to section 3779, such extension shall expire:

(a) On the last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for the filing of the return for the taxable year of the expected net operating loss or unused excess profits credit; or

(b) If an application for a tentative carry-back adjustment provided in section 3780 with respect to such loss or unused credit is filed before the expiration of the period specified in paragraph (a) of this section, on the date on which notice is mailed by registered mail to the taxpayer that such application is allowed or disallowed in whole or in part.

§ 39.3779-6 *Revised statements.* (a) A corporation may file more than one statement under section 3779 with respect to any one taxable year. Each statement is to be considered a new statement and not an amendment of any prior statement. Each such new statement is to be in lieu of the last statement previously filed with respect to the taxable year and may extend the time for payment of a greater or lesser amount of tax than was extended under the prior statement. The extension may not relate to any amount of tax which was paid or required to be paid prior to the date of filing the new statement. Any amount of tax the time for payment of which was extended under a prior statement, however, may continue to be extended under the new statement. If the amount the time for payment of which is extended under the new statement is less than the amount so extended under the last statement previously filed, the extension of time shall be terminated on the date the new statement is filed as to the difference between the two amounts. See section 3779 (g) for the dates on which such difference must be paid. If a corporation pays any amount of tax, the time for payment of which was extended, prior to the date the extension would otherwise terminate, the extension with respect to such amount shall be deemed terminated, without regard to whether a new statement is filed, on the date such amount is paid. The corporation shall indicate on each new statement filed that it has already filed one or more prior statements with respect to the taxable year. The corporation shall likewise indicate the dates each prior statement was filed and the amount of each tax the time for payment of which was extended under each prior statement.

(b) The provisions of this section may be illustrated by the following example:

Example. Corporation B, which keeps its books and makes its tax returns on the calendar year basis, filed its income tax return for 1952 on March 15, 1953, showing a tax of $100,000. At the same time it filed a statement under section 3779 in which it stated that it expected to have a net operating loss of $75,000 in 1953 and that the reduction in the tax previously determined for 1952, attributable to the expected net operating loss carry-back resulting from such expected loss, would be $39,000. The corporation accordingly extended the time for payment of $39,000 of its income tax for 1952, and paid $24,400 of such tax on March 15, 1953 (see section 3779 (c) and § 39.3779-4). As a result of its operations during the next several months, the corporation filed a second statement on June 1, 1953, in which it stated that its expected net operating loss for 1953 would amount to $150,000 and that the corresponding reduction in the tax for 1952 would amount to $78,000. Corporation B under the new statement may extend the time for payment of $39,000 of the installments due on June 15, 1953, September 15, 1953, and December 15, 1953, and the time for payment of the $39,000 extended under the first statement filed on March 15, 1953, may continue to be extended under the second statement. The $24,400 which was paid on March 15, 1953, will not be affected by the second statement filed on June 1, 1953. If the corporation had failed to pay the $24,400 on March 15, 1953, and had not secured an extension of time under section 56 (c) until at least June 1, 1953, with respect to such amount, the time for payment of such $24,400 could not be extended under the second statement filed on June 1, 1953.

(c) The corporation in paragraph (b) might file a second statement to show that it had overestimated the amount of its expected net operating loss and, accordingly, to terminate the extension with respect to part or all of the tax. The corporation might file a second statement even though its estimate of its expected net operating loss had not changed since it filed its first statement. For example, the corporation might have computed incorrectly the reduction, attributable to the expected net operating loss carry-back from 1953, in the tax previously determined for 1952. In such case, the corporation might file a second statement showing the correct computation of such reduction and increasing or decreasing the amount of tax the time for payment of which was extended to correspond to the correct computation. The corporation might file a second statement in order to change the kind of tax the time for payment of which is to be extended even though the total amount of tax the time for payment of which was extended is not to be changed.

§ 39.3779-7 *Termination by Commissioner*—(a) *After an examination of the statement filed by the corporation is made.* The Commissioner is authorized to make such examination of the statements filed as he deems necessary and practicable. If upon such examination as he may make, the Commissioner believes that, as of the time he makes the examination, all or any part of the statement is in a material respect erroneous or unreasonable, he will terminate the extension as to any part of the amount to which such extension relates which he deems should be terminated.

(b) *Jeopardy.* If the Commissioner believes that the collection of any amount to which an extension under section 3779 relates is in jeopardy, he will immediately terminate the extension. In the case of such a termination, notice and demand is to be made by the district director for payment of such amount, and there may be no further extension of time under section 3779 with respect to such amount.

§ 39.3779-8 *Payments on termination.* (a) If an extension of time under section 3779 is terminated with respect to any amount either (1) by the filing of a new statement by the taxpayer under section 3779 (e) extending the time for payment of a lesser amount than was extended in a prior statement or (2) by action of the Commissioner under section 3779 (f) after making an examination of the statement filed by the corporation, no further extension of time may be made under section 3779 with respect to such amount. The time for payment of such amount shall be the dates on which payments would have been required if there had been no extension with respect to such amount and the taxpayer had elected under section 56 (b) to pay the tax in installments.

(b) The provisions of this section may be illustrated by the following examples:

Example (1). Corporation C, which keeps its books and makes its tax returns on a calendar year basis, filed its 1952 income tax return, showing a tax of $1,000, on March 15, 1953. At the same time the corporation filed a statement under section 3779 extending the time for payment of the entire $1,000 on the basis of an expected net operating loss carry-back from 1953. On July 1, 1953, the corporation filed a new statement indicating that the reduction, attributable to the expected net operating loss carry-back from 1953, in its income tax for 1952 would be only $600, and thus terminated the above extension to the extent of $400. The time for payment of such $400 may not be extended again, and such $400 is payable as if it were the tax for 1952 and Corporation C had elected to pay such tax in installments. That is, $160 is payable on March 15, 1953, $160 on June 15, 1953, $40 on September 15, 1953, and $40 on December 15, 1953. Interest is payable under section 3779 (i) (2) on such amounts at the rate of 6 percent per annum and is to be computed from the respective dates on which such amounts were payable. Inasmuch as the March 15 and June 15 dates had already passed when Corporation C terminated the extension with respect to the $400, $320 is payable immediately upon such termination, and $40 is payable on September 15, 1953, and $40 on December 15, 1953. The fact that the corporation did not pay the $160 on March 15, 1953, and the $160 on June 15, 1953, is not to be considered such a failure to pay an installment on or before the date fixed for its payment as would make the entire tax become due under the provisions of section 56 (b). Interest, however, will be computed upon the first $160 from March 15, 1953, and upon the second $160 from June 15, 1953. See section 3779 (i) and § 39.3779-9.

Example (2). If Corporation C in example (1) had shown a tax of $1,200 on its return, the other facts being the same, and, accordingly, had paid $80 on March 15, 1953, and $80 on June 15, 1953, then upon the termination as to the $400, $320 would be payable immediately (i. e., $160 which in the light of the termination should have been paid on March 15, 1953, and $160 which should have been paid on June 15, 1953), and two installments of $60 each would be payable on September 15, 1953, and on December 15, 1953. Interest would be computed from the same dates as in example (1).

(c) The examples in paragraph (b) of this section also would apply if the extension of time for the payment of the $400 were terminated by the Commissioner under section 3779 (f) because he believed that the statement filed by Corporation C under section 3779 extending the time for payment of tax was clearly erroneous or unreasonable in a material respect. If, however, the Commissioner on July 1, 1953, terminated the extension with respect to such $400 un-

der section 3779 (h) because he believed the collection of such amount was in jeopardy, the entire $400 would be payable immediately upon notice and demand by the district director of internal revenue. In such case interest would be computed on $160 from March 15, 1953, on $160 from June 15, 1953, and on the remaining $80 from July 1, 1953. See section 3779 (i) and § 39.3779-9.

§ 39.3779-9. *Interest.* (a) Interest is payable on any amount the time for payment of which is extended under section 3779. The interest, which is to be collected as part of such amount, is to be computed at the rates indicated in subparagraphs (1) and (2) of this paragraph from the dates on which payments would have been required if there had been no extension, and the taxpayer had elected under section 56 (b) to pay the tax in installments:

(1) At the rate of 3 percent per annum on so much of such amount as is satisfied by applying or crediting thereto, within the period of extension (see section 3779 (d)) a decrease in tax determined in respect of an application for a tentative carry-back adjustment, as provided in section 3780 (a) to the date of such satisfaction, except that the rate is to be 6 percent per annum upon so much of the satisfied amount as does not exceed the amount of the deficiencies assessed under section 3780 (b) in respect of such application which is not so satisfied; and

(2) At the rate of 6 percent per annum upon the remainder of the amount the time for payment of which was extended to the date such amount is paid.

(b) Interest thus will be payable at the rate of 3 percent per annum upon any amount the time for payment of which has been extended under section 3779 to the extent that such amount is satisfied by applying or crediting thereto, within the period of extension, a decrease in tax determined in respect of an application for a tentative carry-back adjustment under section 3780 (a). The application for the tentative carry-back adjustment must be with respect to the same taxable year as that of the expected net operating loss or unused excess profits credit. In determining whether an amount has been so satisfied, however, the net effect of the carry-back, including any resulting deficiencies, must be taken into account. Interest upon any amount not so satisfied will be payable at the rate of 6 percent per annum.

(c) The provisions of this section may be illustrated by the following example:

Example. Corporation D, which came into existence on January 1, 1952, and which keeps its books and makes its tax returns on the calendar year basis, extended the time for payment of $855 of its income tax for 1952 on the basis of an expected net operating loss carry-back from 1953. The corporation in fact had a net operating loss for 1953, and on March 31, 1954, it filed an application under section 3780 (a) for a tentative carry-back adjustment with respect to the net operating loss carry-back from 1953. The application showed that the corporation's income tax for 1952 was decreased by $455 as a result of the carry-back from 1953. The Commissioner allowed the application in full on June 29, 1954. The $455 decrease in the corporation's income tax for 1952 was applied against the $855 of its income tax for 1952, the time for payment of which had been extended pursuant to the statement previously filed under section 3779. Since the decrease in the corporation's income tax for 1952 was only $455, the corporation paid the remainder of $400 for 1952 in cash within ten days after notice and demand. The reduction in the corporation's income tax as previously determined for 1952, attributable to the net operating loss carry-back from 1953, was only $455, and the corporation therefore should not have extended the time for payment of more than $455 of its 1952 income tax. Inasmuch as only $455 of the amount the time for payment of which had been extended was satisfied by reason of the carry-back, interest is to be collected at the rate of 3 percent per annum on the $455 and at the rate of 6 percent per annum on the remaining $400. The interest will be computed on the $455 and on the $400 at the rates of 3 percent and 6 percent per annum, respectively, as if 40 percent of each such amount were payable on March 15, 1953, 40 percent on June 15, 1953, 10 percent on September 15, 1953, and 10 percent on December 15, 1953. Interest on the $455 will run until the date the reduction in income tax for 1952, determined in respect of the above application for a tentative carry-back adjustment, is applied against the income tax for 1952, the time for payment of which was extended, and interest on the $400 will run until the date such $400 is paid. The corporation, however, will be liable for a penalty of 5 percent of $286.25, or $14.31, for extending the time for payment of an amount substantially in excess of an amount the time for payment of which might properly have been extended. See section 294 (e) and § 39.294-2.

(d) If an extension of time under section 3779 is terminated either by action of the taxpayer (by paying an amount the time for payment of which had been extended or by filing a new statement extending the time for payment of a lesser amount than was extended in a prior statement) or by the Commissioner (because he believes the statement filed was erroneous or unreasonable in a material respect or because he believes that the collection of an amount to which the extension relates is in jeopardy) interest is payable on the amount to which such termination relates at the rate of 6 percent per annum to the date of payment. Likewise, if the taxpayer fails to file an application for a tentative carry-back adjustment prior to the last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for filing the return for the taxable year of the expected net operating loss or unused excess profits credit, interest is payable on the amount to which the extension relates at the rate of 6 percent per annum to the date of payment. In such case interest will be payable at the rate of 6 percent per annum without regard to whether the taxpayer could have filed an application for a tentative carry-back adjustment, which would have been allowed by the Commissioner, prior to such last date and without regard to whether the taxpayer in fact does file such an application at some time after such last date. If part of an amount the time for payment of which has been extended is satisfied by applying or crediting thereto, within the period of extension, a decrease in tax determined in respect of an application for a tentative carry-back adjustment and part is not so satisfied, interest will be payable on the first part at the rate of 3 percent per annum and on the second part at the rate of 6 percent per annum.

(e) The action of the Commissioner in allowing or disallowing an application for a tentative carry-back adjustment determines the interest payable on amounts the time for payment of which has been extended under section 3779; such interest is not to be affected by a later determination by the Commissioner or any court, including The Tax Court of the United States. If, however, the Commissioner determines, either at the time of the termination of the extension or at some time thereafter, that during the period of extension a credit or refund of an overpayment has been allowed or made, or a deficiency assessed, affecting the amount to which the extension under section 3779 relates and that the corporation could not have taken such overpayment or deficiency into account in the statement or in a revised statement, an appropriate adjustment will be made in determining what part of such amount shall bear interest at the rate of 3 percent and what part at the rate of 6 percent per annum.

§ 39.3780 *Statutory provisions; tentative carry-back adjustments.*

SEC. 3780. *Tentative carry-back adjustments*—(a) *Application for adjustment.* A taxpayer may file an application for a tentative carry-back adjustment of the taxes for prior taxable years affected by a net operating loss carry-back, provided in section 122 (b), or an unused excess profits credit carry-back, provided in section 432 (c), from any taxable year ending on or after September 30, 1945. The application shall be verified in the manner prescribed by section 51 or section 52 in the case of a return of such taxpayer, and shall be filed, on or after the date of filing of the return for the taxable year of the net operating loss or unused excess profits credit from which the carry-back results and within a period of twelve months from the end of such taxable year, in the manner and form required by regulations prescribed by the Commissioner with the approval of the Secretary. The application shall set forth, in such detail and with such supporting data and explanation as such regulations shall require—

(1) The amount of the net operating loss or unused excess profits credit;

(2) The amount of the tax previously determined for each prior taxable year affected by such carry-back; the tax previously determined being ascertained in accordance with the method prescribed in section 3801 (d);

(3) The amount of increase or decrease in each such tax, attributable to such carry-back; such increase or decrease being determined by applying the carry-back in the manner provided by law to the items on the basis of which such taxes were determined. If an application under section 124 (j) for tentative adjustment of tax with respect to amortization has been previously filed but such adjustment has not been previously determined, then for the purposes of this section the assessments, applications, credits, and refunds provided for in section 124 (k) shall be considered as having previously been made upon the basis of such application under section 124 (j);

(4) The amount by which the aggregate of such decreases exceeds the aggregate of such increases;

(5) The unpaid amount of each such tax, not including any amount required to be shown under paragraph (6);

(6) The amount, with respect to each tax for the taxable year immediately preceding the taxable year of such loss or unused credit, as to which an extension of time for payment under section 3779 is in effect; and

(7) Such other information for the purposes of carrying out the provisions of this section as may be required by such regulations.

An application under this subsection shall not constitute a claim for credit or refund.

(b) *Allowance of adjustments.* Within a period of ninety days from the date on which an application for a tentative carry-back adjustment is filed under subsection (a), or from the last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for filing the return for the taxable year of the net operating loss or unused excess profits credit from which such carry-back results, whichever is the later, the Commissioner shall make, to the extent he deems practicable in such period, a limited examination of the application, to discover omissions and errors of computation therein, and shall determine the amount of the increase or decrease in each tax attributable to such carry-back upon the basis of the application and the examination, except that the Commissioner may disallow, without further action, any application which he finds contains errors of computation which he deems cannot be corrected by him within such ninety-day period or material omissions. Each such increase shall be deemed determined as a deficiency and shall be assessed, without regard to the restrictions on assessment in section 272. Each such decrease shall be applied against any unpaid amount of the tax decreased (including any amount of such tax as to which an extension of time under section 3779 is in effect) and any remainder shall be credited—

(1) Against the deficiencies (and additions to the tax) assessed under this subsection,

(2) Against any unsatisfied amount of any tax for the taxable year immediately preceding the taxable year of the net operating loss or unused excess profits credit the time for payment of which tax is extended under section 3779, and

any remainder shall, within such ninety-day period, be either credited against any income, war profits, or excess profits tax or instalment thereof then due from the taxpayer, or refunded to the taxpayer. The application, credit or refund of a decrease determined under this subsection shall be deemed a credit or refund of an overpayment within the meaning of sections 781 (b) and 3807 (b) (1).

(c) *Assessment of erroneous allowances.* If the Commissioner determines that the amount applied, credited or refunded under subsection (b) is in excess of the overassessment attributable to the carry-back with respect to which such amount was applied, credited or refunded, he may assess the amount of the excess as a deficiency as if it were due to a mathematical error appearing on the face of the return, as provided in section 272 (f). Upon making such assessment, the Commissioner shall schedule as an overassessment the decrease in any other tax resulting from the adjustments reflected in the computation of the deficiency.

[Sec. 3780 as added by sec. 4 (a), Tax Adjustment Act; amended by sec. 304 (b), Excess Profits Tax Act 1950]

§ 39.3780-1

§ 39.3780-1 *Tentative carry-back adjustments*—(a) *In general.* Any taxpayer who claims a net operating loss or unused excess profits credit may file an application under section 3780 for a tentative carry-back adjustment of the taxes for all taxable years prior to the taxable year of the loss or unused credit which are affected by the net operating loss carry-back or the unused excess profits credit carry-back resulting from such loss or unused credit. The right to file an application for a tentative carry-back adjustment is not limited to corporations, but is available to any taxpayer who has a carry-back. A corporation may file an application for a tentative carry-back adjustment even though it has not extended the time for payment of tax under section 3779. If a corporation has both a net operating loss and an unused excess profits credit, it may file an application for a tentative carry-back adjustment in respect of both the net operating loss carry-back and the unused excess profits credit carry-back resulting from such loss and unused credit.

(b) *Contents of application.* (1) The application for a tentative carry-back adjustment in the case of a corporation is to be filed on Form 1139, and in the case of taxpayers other than corporations on Form 1045. The applications are to be filled out in accordance with the instructions accompanying such forms, and all information required by the forms and the instructions must be furnished by the taxpayer. The application shall contain or be verified by a written declaration that it is made under penalties of perjury.

(2) An application for a tentative carry-back adjustment does not constitute a claim for credit or refund. If such application is disallowed by the Commissioner in whole or in part, no suit may be maintained in any court for the recovery of any tax based on such application. The taxpayer, however, may file a regular claim for credit or refund under section 322 at any time prior to the expiration of the applicable period of limitation, and may maintain a suit based on such claim if it is disallowed or if the Commissioner does not act on the claim within six months from the date it is filed. Such regular claim may be filed before, simultaneously with, or after the filing of the application for a tentative carry-back adjustment. The filing of an application for a tentative carry-back adjustment will not constitute the filing of a claim for credit or refund within the meaning of section 322 (b) for purposes of determining whether a claim for credit or refund was filed prior to the expiration of the applicable period of limitation. A regular claim for credit or refund under section 322 filed after the filing of an application for a tentative carry-back adjustment is not to be considered an amendment of such application but is to be considered a new claim. Such regular claim, however, in proper cases may constitute an amendment to a prior regular claim filed under section 322.

(c) *Time and place of filing application.* The application for a tentative carry-back adjustment is to be filed on or after the date of the filing of the return for the taxable year of the net operating loss or the unused excess profits credit, and must be filed within a period of 12 months from the end of such taxable year. Any application filed prior to the date the return for the taxable year of the loss or unused credit is filed shall be considered to have been filed on the date such return is filed. The application is to be filed with the district director of internal revenue where the tax was paid or the assessment was made.

§ 39.3780-2 *Computation of increase or decrease in prior years' taxes affected by the carry-back.* (a) The taxpayer is to determine the amount of increase or decrease, attributable to the carry-back, in each tax previously determined, which is affected by such carry-back, for each taxable year before the taxable year of the net operating loss or unused excess profits credit. The tax previously determined is to be ascertained in accordance with the method prescribed in section 3801 (d) In general, therefore, the tax previously determined will be the tax shown on the return as filed, increased by any amounts assessed (or collected without assessment) as deficiencies before the date of the filing of the application for a tentative carry-back adjustment, and decreased by any amounts abated, credited, refunded, or otherwise repaid prior to such date. Any items as to which the Commissioner and the taxpayer are in disagreement at the time of the filing of the application shall be taken into account in ascertaining the tax previously determined only if, and to the extent that, they were reported in the return, or were reflected in any amounts assessed (or collected without assessment) as deficiencies, or in any amounts abated, credited, refunded, or otherwise repaid, before the date of filing the application. The tax previously determined, therefore, will reflect the foreign tax credit and the credit for tax withheld at source provided in section 32.

(b) The increase or decrease in each tax previously determined which is affected by the carry-back or any related adjustments, is to be determined, except for such carry-back and related adjustments, on the basis of the items which entered into the computation of such tax as previously determined; the tax previously determined being ascertained in the manner described in this section. In determining any such increase or decrease accordingly, items shall be taken into account only to the extent that they were reported in the return, or were reflected in amounts assessed (or collected without assessment) as deficiencies, or in amounts abated, credited, refunded, or otherwise repaid, before the date of filing the application for a tentative carry-back adjustment. If the Commissioner and the taxpayer are in disagreement as to the proper treatment of any item, it shall be assumed for purposes of determining the increase or decrease in

the tax previously determined that such item was correctly reported by the taxpayer unless, and to the extent that, the disagreement has resulted in the assessment of a deficiency (or the collection of an amount without an assessment) or the allowing or making of an abatement, credit, refund, or other repayment, before the date of filing the application. Thus, if the taxpayer claimed a deduction on its return of $50,000 for salaries paid its officers but the Commissioner asserts that such deduction should not exceed $20,000, and the Commissioner and the taxpayer have not agreed on the amount properly deductible before the date the application for a tentative carry-back adjustment is filed, $50,000 shall be considered as the amount properly deductible for purposes of determining the increase or decrease in each tax previously determined in respect of the application for a tentative carry-back adjustment. In determining the increase or decrease in any tax previously determined, any items which are affected by the carry-back must be adjusted to reflect such carry-back. Thus, any deduction limited, for example, by net income or adjusted gross income, such as the deduction for charitable contributions, is to be recomputed on the basis of the net income or adjusted gross income as affected by the carry-back. Similarly, in any case where one tax is allowable as a deduction in computing a second tax, or where the income subject to one tax is a credit in computing the income subject to the second tax, such deduction or credit must be adjusted to reflect such carry-back. In computing the net operating loss deduction for purposes of determining any such increase or decrease, proper adjustments as required by section 122 (c) and 433 (a) (1) (J) are to be made.

§ 39.3780-3 *Allowance of adjustments.* (a) The Commissioner is to act upon any application for a tentative carry-back adjustment filed under section 3780 (a) within a period of 90 days from whichever of the following two dates is the later:

(1) The date the application is filed; or

(2) The last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for filing the return for the taxable year of the net operating loss or unused excess profits credit from which the carry-back results.

(b) Within the 90-day period described in paragraph (a) of this section, the Commissioner will make, to the extent he deems practicable in such period, an examination of the application to discover omissions and errors of computation. He is to determine within such period the increase or decrease in any tax previously determined, affected by the carry-back or any related adjustments, upon the basis of the application and such examination. Such increases and decreases are to be determined in the same manner as that provided in section 3780 (a) for the determination by the taxpayer of the increases and decreases in taxes previously determined which must be set forth in the application for a tentative carry-back adjustment. The Commissioner, however, may correct any errors of computation or omissions he may discover upon examination of the application. In determining the increase or decrease in each tax previously determined which is affected by the carry-back or any related adjustments, he accordingly may correct any mathematical error appearing on the application and he may likewise correct any adjustment required by the law and incorrectly made by the taxpayer in computing its net operating loss, its unused excess profits credit, the resulting carry-backs, or its net operating loss deduction or unused excess profits credit adjustment. If the required adjustment has not been made by the taxpayer and the Commissioner has available the necessary information to make such adjustment within the 90-day period, he may, in his discretion, make such adjustment. Thus, if the taxpayer's application fails to take into account certain tax-free interest which he received in the year of the net operating loss, or in a prior year the taxes for which are affected by the resulting net operating loss carry-back, the Commissioner, if he knows the amount of such tax-free interest received by the taxpayer in such year, may take such tax-free interest into account in determining the increases and decreases in the taxes previously determined which are affected by the carry-back. In determining such increases and decreases, however, the Commissioner will not, for example, change the amount claimed on the return as a deduction for depreciation because he believes that the taxpayer has claimed an excessive amount; likewise, he will not include in gross income any amount not so included by the taxpayer even though the Commissioner believes that such amount is subject to tax and properly should be included in gross income.

(c) If the Commissioner finds that an application for a tentative carry-back adjustment contains material omissions or errors of computation, he may disallow such application in whole or in part without further action. If, however, he deems that any error of computation can be corrected by him within the 90-day period, he may do so and allow the application in whole or in part. The Commissioner's determination as to whether he can correct any error of computation within the 90-day period shall be conclusive. Similarly, his action in disallowing, in whole or in part, any application for a tentative carry-back adjustment shall be final and may not be challenged in any proceeding. The taxpayer in such case, however, may file a regular claim for credit or refund under section 322, and may maintain a suit based on such claim if it is disallowed or if the Commissioner does not act upon the claim within six months from the date it is filed.

(d) In the case of any application for a tentative carry-back adjustment which the Commissioner allows in whole or in part, any increase determined by the Commissioner in any tax previously determined which is affected by the carry-back or any related adjustments shall be deemed to have been determined as a deficiency and shall be assessed without regard to the restrictions on assessment provided in section 272. Such increase may be assessed, for example, without regard to whether a notice of deficiency in respect of such increase is sent to the taxpayer and without regard to whether a prior notice of deficiency has been mailed to the taxpayer. The taxpayer will not have the right to contest the assessment before The Tax Court of the United States whether or not the Commissioner sends him a notice in respect of such increase.

(e) (1) Each decrease determined by the Commissioner in any tax previously determined which is affected by the carry-back or any related adjustments shall first be applied against any unpaid amount of the tax with respect to which such decrease was determined. Such unpaid amount of tax may include one or more of the following:

(i) An amount with respect to which the taxpayer is delinquent;

(ii) An amount the time for payment of which has been extended under section 3779 which is due and payable on or after the date on which the decrease is allowed; and

(iii) An amount (including an amount the time for payment of which has been extended under section 56 (c), but not including an amount the time for payment of which has been extended under section 3779) which is due and payable on or after the date on which the decrease is allowed.

(2) In case the unpaid amount of tax includes more than one of such amounts, the Commissioner, in his discretion, shall determine against which amount or amounts, and in what proportion, the decrease is to be applied. In general, however, the decrease will be applied against any amounts described in subdivisions (i), (ii), and (iii) of subparagraph (1) in the order named. If there are several amounts of the type described in subdivision (iii) any amount of the decrease which is to be applied against such amounts will be applied by assuming that the tax previously determined minus the amount of the decrease to be so applied is "the tax" and the taxpayer had elected to pay such tax in installments. The unpaid amount of tax against which a decrease may be applied may not include any amount of tax for any taxable year other than the year of the decrease. After making such application, the Commissioner will credit any remainder of the decrease as follows:

(i) Against any increase (including additions to the tax) determined in any tax which is attributable to the carry-back or any related adjustments and which has been assessed under section 3780 (b) and then

(ii) Against any unsatisfied amount of any tax for the taxable year immediately preceding the taxable year of the net operating loss or the unused excess prof-

its credit the time for payment of which has been extended under section 3779.

(3) Any remainder of the decrease after such application and credits may, within the 90-day period, in the discretion of the Commissioner, be credited against any income, war profits, or excess profits tax or installment thereof then due from the taxpayer, and, if not so credited, is to be refunded to the taxpayer within such 90-day period.

§ 39.3780-4 *Assessment of erroneous allowances.* (a) If the Commissioner determines that any amount applied, credited, or refunded under section 3780 (b) with respect to an application for a tentative carry-back adjustment is in excess of the overassessment properly attributable to the carry-back upon which such application was based, he may assess the amount of the excess as a deficiency as if such deficiency were due to a mathematical error appearing on the face of the return. That is, the Commissioner may assess an amount equal to the excess, and such amount may be collected, without regard to the restrictions on assessment and collection imposed by section 272. Thus, the Commissioner, for example, may assess such amount without regard to whether he has mailed the taxpayer a prior notice of deficiency. Either before or after assessing such an amount, the Commissioner will notify the taxpayer that he has made, or will make, such assessment. Such notice will not constitute a notice of deficiency, and the taxpayer may not file a petition with The Tax Court of the United States based on such notice. The taxpayer, however, within the applicable period of limitation may file a regular claim for credit or refund under section 322 based on the carry-back, if he has not already filed such a claim, and may maintain a suit based on such claim if it is disallowed or if it is not acted upon by the Commissioner within six months from the date the claim was filed.

(b) Upon assessing any deficiency under section 3780 (c) the Commissioner will schedule as an overassessment the decrease in any other tax resulting from the adjustments reflected in the computation of the deficiency so assessed. In any such case the taxpayer will be required to pay only the difference between the overassessment and the deficiency in satisfaction of the deficiency.

(c) The method provided in section 3780 (c) to recover any amount applied, credited, or refunded in respect of an application for a tentative carry-back adjustment which the Commissioner later determines should not have been so applied, credited, or refunded is not an exclusive method. Two other methods are available to recover such amount: (1) by way of a deficiency notice under section 272 (a) or (2) by a suit to recover an erroneous refund under section 3746. The Commissioner, in his discretion, may proceed by way of any one or more of the three available methods to recover any amount which he determines was improperly applied, credited, or refunded in respect of an application for a tentative carry-back adjustment.

§ 39.3781 *Statutory provisions; extension of time and tentative carry-back and amortization adjustments in the case of consolidated returns.*

SEC. 3781. *Extension of time and tentative carry-back and amortization adjustments in the case of consolidated returns.* If the corporation seeking an extension of time under section 3779, a tentative carry-back adjustment under section 3780, or a tentative adjustment with respect to an amortization deduction under section 124 (j) and (k), made or was required to make a consolidated return, either for the taxable year within which the net operating loss or the unused excess profits credit arises or within which the election is made to terminate the amortization period, or for a preceding taxable year affected by such loss, credit, or election, the provisions of such sections shall apply only to such extent and subject to such conditions, limitations, and exceptions as the Commissioner, with the approval of the Secretary, may by regulations prescribe.

[Sec. 3781 as added by sec. 4 (a), Tax Adjustment Act 1945]

ADDITIONAL MISCELLANEOUS PROVISIONS

§ 39.3790-3795 *Statutory provisions; prohibition of administrative review of Commissioner's decisions; rules and regulations; expenses of detection and punishment of frauds; penalties and forfeitures; interest on delinquent taxes; administration of real estate acquired by the United States.*

SEC. 3790. *Prohibition of administrative review of Commissioner's decisions.* In the absence of fraud or mistake in mathematical calculation, the findings of facts in and the decision of the Commissioner upon (or in case the Secretary is authorized to approve the same, then after such approval) the merits of any claim presented under or authorized by the internal revenue laws shall not, except as provided in chapter 5, be subject to review by any other administrative or accounting officer, employee, or agent of the United States. In the absence of fraud or mistake in mathematical calculation, the allowance or nonallowance by the Commissioner, of interest on any credit or refund under the internal revenue laws shall not, except as provided in chapter 5, be subject to review by any other administrative or accounting officer, employee, or agent of the United States.

[Sec. 3790 as amended by sec. 4 (f), Current Tax Payment Act 1943]

SEC. 3791. *Rules and regulations*—(a) *Authorization*—(1) *In general.* * * * the Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this title.

(2) *In case of change in law.* The Commissioner may make all such regulations, not otherwise provided for, as may have become necessary by reason of any alteration of law in relation to internal revenue.

(b) *Retroactivity of regulations or rulings.* The Secretary, or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect.

SEC. 3792. *Expenses of detection and punishment of frauds.* The Commissioner, under regulations prescribed by him with the approval of the Secretary, is authorized to pay such sums, not exceeding in the aggregate the sum appropriated therefor, as he may deem necessary for detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws, or conniving at the same, in cases where such expenses are not otherwise provided for by law.

[Sec. 3792 as amended by sec. 12, Pub. Law 271 (81st Cong.)]

SEC. 3793. *Penalties and forfeitures*—(a) *Fraudulent bonds, permits, and entries*—(1) *Penalty.* Every person who—

(A) *Simulation or execution.* Simulates or falsely or fraudulently executes or signs any bond, permit, entry, or other document required by the provisions of the internal revenue laws, or by any regulation made in pursuance thereof, or

(B) *Procuring execution.* Procures the same to be falsely or fraudulently executed, or

(C) *Aiding in execution.* Advises, aids in, or connives at such execution thereof—

shall be imprisoned for a term not less than one year nor more than five years, and

(2) *Forfeiture.* The property to which such false or fraudulent instrument relates shall be forfeited.

(b) *Fraudulent returns, affidavits, and claims*—(1) *Assistance in preparation or presentation.* Any person who willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a false or fraudulent return, affidavit, claim, or document, shall (whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document) 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.

(2) *Person defined.* The term "person" as used in this subsection 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.

(c) *Cross references.* * * *

SEC. 3794. *Interest on delinquent taxes.* Notwithstanding any provision of law to the contrary, interest accruing during any period of time after August 30, 1935, upon any internal-revenue tax (including amounts assessed or collected as a part thereof) not paid when due, shall be at the rate of 6 per centum per annum.

SEC. 3795. *Administration of real estate acquired by the United States*—(a) *Person charged with.* The Commissioner shall have charge of all real estate which is or shall become the property of the United States by judgment or forfeiture under the internal revenue laws, or which has been or shall be assigned, set off, or conveyed by purchase or otherwise to the United States in payment of debts or penalties arising under the laws relating to internal revenue, or which has been or shall be vested in the United States by mortgage or other security for the payment of such debts, and of all trusts created for the use of the United States in payment of such debts due them.

(b) *Sale.* The Commissioner, with the approval of the Secretary, may, at public vendue, and upon not less than twenty days' notice, sell and dispose of all real estate owned or held by the United States as aforesaid.

(c) *Lease.* Until such sale the Commissioner, with the approval of the Secretary, may lease such real estate owned as aforesaid on such terms and for such period as they shall deem expedient.

(d) *Release to debtor.* In cases where real estate has or may become the property of the United States by conveyance or otherwise, in payment of or as security for a debt

arising under the laws relating to internal revenue, and such debt shall have been paid, together with the interest thereon, at the rate of 1 per centum per month, to the United States, within two years from the date of the acquisition of such real estate, it shall be lawful for the Commissioner, with the approval of the Secretary, to release by deed, or otherwise convey such real estate to the debtor from whom it was taken, or to his heirs or other legal representatives.

§ 39.3797 *Statutory provisions; definitions.*

SEC. 3797. *Definitions.* (a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

(1) *Person.* The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, company, or corporation.

(2) *Partnership and partner.* The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization. A person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

(3) *Corporation.* The term "corporation" includes associations, joint-stock companies, and insurance companies.

(4) *Domestic.* The term "domestic" when applied to a corporation or a partnership means created or organized in the United States or under the law of the United States or of any State or Territory.

(5) *Foreign.* The term "foreign" when applied to a corporation or partnership means a corporation or partnership which is not domestic.

(6) *Fiduciary.* The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.

(7) *Stock.* The term "stock" includes the share in an association, joint-stock company, or insurance company.

(8) *Shareholder.* The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

(9) *United States.* 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.

(10) *State.* The word "State" shall be construed to include the Territories and the District of Columbia, where such construction is necessary to carry out provisions of this title.

(11) *Secretary.* The term "Secretary" means the Secretary of the Treasury.

(12) *Commissioner.* The term "Commissioner" means the Commissioner of Internal Revenue.

(13) *Collector.* The term "collector" means collector of internal revenue.

(14) *Taxpayer.* The term "taxpayer" means any person subject to a tax imposed by this title.

(15) *Military or naval forces of the United States.* The term "military or naval forces of the United States" includes the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, the Women's Army Auxiliary Corps, the Navy Nurse Corps, Female, and the Women's Reserve branch of the Naval Reserve.

(16) *Withholding agent.* The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 143 or 144.

(17) *Husband and wife.* As used in sections 22 (k), 23 (u), 171, and the last sentence of section 25 (b) (3), if the husband and wife therein referred to are divorced, wherever appropriate to the meaning of such sections, the term "wife" shall be read "former wife" and the term "husband" shall be read "former husband" and, if the payments described in such sections are made by or on behalf of the wife or former wife to the husband or former husband instead of vice versa, wherever appropriate to the meaning of such sections, the term "husband" shall be read "wife" and the term "wife" shall be read "husband"

(18) *International organization.* The term "international organization" means a public international organization entitled to enjoy privileges, exemptions, and immunities as an international organization under the International Organizations Immunities Act.

(19) *Domestic building and loan association.* The term "domestic building and loan association" means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association, substantially all the business of which is confined to making loans to members.

(20) *Employee.* For the purpose of applying the provisions of chapter 1 with respect to contributions to or under a stock bonus, pension, profit-sharing, or annuity plan, and with respect to distributions under such a plan or by a trust forming part of such a plan, the term "employee" shall include a full-time life insurance salesman who is considered an employee for the purpose of subchapter A of chapter 9, or, in the case of services performed before January 1, 1951, who would be considered an employee if his services were performed during 1951.

(b) *Includes and including.* The terms "includes" and "including" when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined.

(c) *Cross references.* For other definitions, see the following:

Singular as including plural, R. S. 1 (U. S. C., Title 1, sec. 1).

Plural as including singular, R. S. 1 (U. S. C., Title 1, sec. 1).

Masculine as including feminine, R. S. 1 (U. S. C., Title 1, sec. 1).

Officer, R. S. 1 (U. S. C., Title 1, sec. 1).

Oath as including affirmation, R. S. 1 (U. S. C., Title 1, sec. 1).

Company or association as including successors and assigns, R. S. 5 (U. S. C., Title 1, sec. 5).

County as including parish, R. S. 2 (U. S. C., Title 1, sec. 2).

Vessel as including all means of water transportation, R. S. 3 (U. S. C., Title 1, sec. 3).

Vehicle as including all means of land transportation, R. S. 4 (U. S. C., Title 1, sec. 4).

[Sec. 3797 as amended by secs. 120 (f) and 511, Rev. Act 1942; sec. 10 (i), Rev. Act 1944; sec. 4 (i), Pub. Law 291 (79th Cong.); secs. 313 (i), 340 (a), and 343 (a), Rev. Act 1951.]

§ 39.3797-1 *Classification of taxables.* For the purpose of taxation the Internal Revenue Code 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 § 39.3797-3. 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 § 39.3797-4. 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 §§ 39.3797-2 and 39.3797-4. See section 191 and the regulations thereunder, for recognition as a partner of any person who owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person. The definitions, terms, and classifications, as set forth in section 3797, shall have the same respective meaning and scope in the regulations in this part.

§ 39.3797-2 *Association.* The term "association" is not used in the Internal Revenue Code 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 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 Code, a trust or an estate, or a partnership. An "investment" trust of the type commonly known as a management trust is an association, and a trust of the type commonly known as a fixed investment trust is an association if there is power under the trust agreement to vary the investment of the certificate holders. See Commissioner v. North American Bond Trust, 122 F. (2d) 545, cert. denied 314 U. S. 701. 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.

§ 39.3797-3 *Association distinguished from trust.* (a) The term "trust," as used in the Internal Revenue Code, 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 bene-

ficiaries 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.

(b) As distinguished from the ordinary trust described in the preceding paragraph there 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.

(c) 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 Internal Revenue Code 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.

(d) 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 Internal Revenue Code 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.

(e) 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.

§ 39.3797-4 *Partnerships.* (a) The Internal Revenue Code 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 Code, a trust, estate, or a corporation. On the other hand the Code 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 §§ 39.3797-2 and 39.3797-3. See section 191 and the regulations thereunder, for treatment as a partner of any person who owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

(b) The following examples will illustrate some phases of the distinctions described in paragraph (a) of this section:

(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 Code 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.

§ 39.3797-5 *Limited partnerships.* (a) A limited partnership is classified for the purpose of the Internal Revenue Code as an ordinary partnership, or, on the other hand, as an association taxable as a corporation, depending upon its character in certain material respects. If the organization is not interrupted by the death of a general partner or by a change in the ownership of his participating interest, and if the management of its affairs is centralized in one or more persons acting in a representative capacity, it is taxable as a corporation. For want of these essential characteristics, a limited partnership is to be considered as an ordinary partnership notwithstanding other characteristics conferred upon it by local law.

(b) The Uniform Limited Partnership Act has been adopted in several States. A limited partnership organized under the provisions of that Act may be either an association or a partnership depending upon whether or not in the particular case the essential characteristics of an association exist.

§ 39.3797-6 *Partnership associations.* A partnership association of the type authorized by the statutes of several States, such, for instance, as those of the State of Pennsylvania (Purdon's Penna. Stat. Ann., (Perm. Ed.), Title 59, ch. 3), having by virtue of the statutory provisions under which it was organized, the characteristics essential to an association within the meaning of the Internal Revenue Code, is taxable as a corporation.

§ 39.3797-7 *Insurance company.* (a) 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.

(b) 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

Internal Revenue Code. For example, during the year 1952 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 1952 within the meaning of the Code and the regulations in this part.

§ 39.3797-8 *Domestic, foreign, resident, and nonresident persons.* (a) 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 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, as a nonresident foreign corporation. A partnership engaged in trade or business within the United States is referred to in these regulations as a resident partnership, and a partnership not engaged in trade or business within the United States, 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 the regulations in this part, includes a nonresident alien individual and a nonresident alien fiduciary.

§ 39.3797-9 *Fiduciary.* "Fiduciary" is a term which applies to persons who 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.

§ 39.3797-10 *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 Internal Revenue Code. 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.

§ 39.3797-11 *Military or naval forces and armed forces of the United States.* The term "military or naval forces of the United States" and the term "armed forces of the United States" each includes all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force. The terms also include the Coast Guard. The members of such forces include commissioned officers and the personnel below the grade of commissioned officer in such forces.

§ 39.3797-12 *Collectors and directors.* In the regulations in this part, references to collectors of internal revenue shall be construed to be references to directors of internal revenue or district directors of internal revenue, where appropriate, and references to district directors of internal revenue shall be construed to be references to collectors of internal revenue or directors of internal revenue, where appropriate. Similarly, references to deputy collectors shall be construed to be references to internal revenue agents, where appropriate, and references to internal revenue agents shall be construed to be references to deputy collectors, where appropriate.

§ 39.3798 *Statutory provisions; exemption of insolvent banks from tax.*

SEC. 3798. *Exemption of insolvent banks from tax.* (a) Whenever and after any bank or trust company, a substantial portion of the business of which consists of receiving deposits and making loans and discounts, has ceased to do business by reason of insolvency or bankruptcy, no tax shall be assessed or collected, or paid into the Treasury of the United States on account of such bank, or trust company, which shall diminish the assets thereof necessary for the full payment of all its depositors; and such tax shall be abated from such national banks as are found by the Comptroller of the Currency to be insolvent; and the Commissioner of Internal Revenue, when the facts shall appear to him, is authorized to remit so much of the said tax against any such insolvent banks and trust companies organized under State law as shall be found to affect the claims of their depositors.

(b) Whenever any bank or trust company, a substantial portion of the business of which consists of receiving deposits and making loans and discounts, has been released or discharged from its liability to its depositors for any part of their claims against it, and such depositors have accepted, in lieu thereof, a lien upon subsequent earnings of such bank or trust company, or claims against assets segregated by such bank or trust company or against assets transferred from it to an individual or corporate trustee or agent, no tax shall be assessed or collected, or paid into the Treasury of the United States on account of such bank, or trust company, such individual or corporate trustee or such agent, which shall diminish the assets thereof which are available for the payment of such depositor claims and which are necessary for the full payment thereof.

(c) (1) Any such tax collected, whether collected before, on, or after the date of enactment of the Revenue Act of 1938, shall be deemed to be erroneously collected, and shall be refunded subject to all provisions and limitations of law, so far as applicable, relating to the refunding of taxes.

(2) Any tax, the assessment, collection, or payment of which is barred under subsection (a) of this section, or any such tax which has been abated or remitted after May 28, 1938, shall be assessed or reassessed whenever it shall appear that payment of the tax will not diminish the assets as aforesaid.

(3) Any tax, the assessment, collection, or payment of which is barred under subsection (b) of this section or any such tax which has been refunded after May 28, 1938, shall be assessed or reassessed after full payment of such claims of depositors to the extent of the remaining assets segregated or transferred as described in subsection (b).

(4) The running of the statute of limitations on the making of assessment and collection shall be suspended, during, and for ninety days beyond, the period for which, pursuant to this section, assessment or collection may not be made, and a tax may be reassessed as provided in paragraphs (2) and (3) of this subsection, and collected, during the time within which, had there been no abatement, collection might have been made.

(d) This section shall not apply to any tax imposed by subchapter A or subchapter C of chapter 9.

[Sec. 3798 as amended by sec. 406 (a), Rev. Act 1939]

SEC. 406 (b). *Insolvent banks* [Revenue Act of 1939].

(b) The term "agent" as used in 3798 (b) of the Internal Revenue Code shall be deemed to include a corporation acting as a liquidating agent.

§ 39.3798-1 *Banks and trust companies covered.* (a) Section 3798 applies to any national bank, or bank or trust company organized under State law, a substantial portion of the business of which consists of receiving deposits and making loans and discounts, and which has—

(1) Ceased to do business by reason of insolvency or bankruptcy, or

(2) Been released or discharged from its liability to its depositors for any part of their deposit claims, and the depositors have accepted in lieu thereof a lien upon its subsequent earnings or claims against its assets either (i) segregated and held by it for benefit of the depositors or (ii) transferred to an individual or corporate trustee or agent who liquidates, holds or operates the assets for the benefit of the depositors.

(b) As used in the regulations under section 3798:

(1) The term "bank" unless otherwise indicated by the context, means any national bank, or bank or trust company organized under State law, within the scope of such section.

(2) The terms "statute of limitations" and "limitations" means all applicable provisions of law (including section 3798) which impose, change, or affect the limitations, conditions, or requirements relative to the allowance of refunds and abatements or the assessment or collection of tax, as the case may be.

(3) The term "segregated assets" includes transferred or trusteed assets, or assets set aside or earmarked, to all or a portion of which, or the proceeds of which, the depositors are absolutely or conditionally entitled.

§ 39.3798-2 *Scope of section generally*—(a) *Purpose.* Section 3798 is

intended to assist depositors of a bank which had ceased to do business by reason of insolvency to recover their deposits, by prohibiting collection of taxes of the bank which would diminish the assets necessary for payment of its depositors and also assist depositors of banks which are in financial difficulties but which, in certain conditions, continue in business.

(b) *Requisites of application.* In order that section 3798 shall operate in a case where the bank continues business it is necessary that the depositors shall agree to accept, in lieu of all or a part of their deposit claims as such, claims against segregated assets, or a lien upon subsequent earnings of the bank, or both. When such an agreement exists, no tax diminishing such assets or earnings, or both, otherwise available and necessary for payment of depositors, may be collected therefrom. If, under such an agreement, the depositors have the right also to look to the unsegregated assets of the bank for recovery, in whole or part, the unsegregated assets are likewise, until they exceed the amount of the depositors' claims chargeable thereto, unavailable for tax collection. Any tax of such a bank, or part of any tax, which is once uncollectible under section 3798, cannot thereafter be collected except from any residue of segregated assets remaining after claims of depositors against such assets have been paid.

(c) *Interest.* For the purposes of section 3798, depositors' claims include bona fide interest, either on the deposits as such, or on the claims accepted in lieu of deposits as such.

(d) *Limitations on immunity.* Section 3798 is not primarily intended for the relief of banks as such. It does not prevent tax collection, from assets not necessary, or not available, for payment of depositors, from a bank within section 3798 (a) at any time within the statute of limitations. In other words the immunity of such a bank is not complete, but ceases whenever, within the statutory period for collection, it becomes possible to make collection without diminishing assets necessary for payment of depositors. In the case of a bank within section 3798 (b) any immunity to which the bank is entitled is absolute except as to segregated assets. Any tax coming within such immunity may never be collected. With respect to segregated assets, such a bank is subject to the same rule as a bank within section 3798 (a) that is to say after claims of depositors against segregated assets have been paid, any surplus is subject, within the statute of limitations, to collection of any tax, due at any time, the collection of which was suspended by the section. The section is not for the relief of creditors other than depositors, although it may incidentally operate for their benefit. See §§ 39.3798-4 and 39.3798-9 (b)

§ 39.3798-3 *Segregated or transferred assets*—(a) *In general.* In a case involving segregated or transferred assets, it is not necessary for application of section 3798, that the assets shall technically constitute a trust fund. It is sufficient that segregated assets be definitely separated from other assets of the bank and that transferred assets be definitely separated both from other assets of the bank and from other assets held or owned by the trustee or agent to whom assets of the bank have been transferred; that the bank be wholly or partially released from liability for repayment of deposits as such; and that the depositors have claims against the separated assets. Any excess of separated assets over the amount necessary for payment of such depositors will be available for tax collection after full payment of depositors' claims under the agreement against such assets. But see § 39.3798-9 (a)

(b) *Corporate transferees.* Where the segregated assets are transferred to a separate corporate trustee or corporate agent, the assets and earnings therefrom are within the protection of the section, until full payment of depositors' claims against such assets and earnings, no matter by whom the stock of such corporation is held, and no matter whether the assets be liquidated or operated or held for benefit of the depositors.

§ 39.3798-4 *Unsegregated assets*—(a) *Depositors' claims against assets.* (1) Claims of depositors, to the extent that they are to be satisfied out of segregated assets, will not be considered in determining the availability of unsegregated assets for tax collection. If depositors have agreed to accept payment out of segregated assets only, collection of tax from unsegregated assets will not diminish the assets available and necessary for payment of the depositors' claims. Thus, it may be possible to collect taxes from the unsegregated assets of a bank although the segregated assets are immune under the section.

(2) If the unsegregated assets of the bank are subject to any portion of the depositors' claims, such unsegregated assets will be within the immunity of the section only to the extent necessary to satisfy the claims to which such assets are subject. Taxes will still be collectible from the unsegregated assets to the extent of the amount by which the total value of such assets exceeds the liability to depositors to be satisfied therefrom. Therefore, if, for example, in the case of a bank having a tax liability not previously immune under the section, of $50,000, the deposit claims against the bank are in the amount of $75,000, and the assets available for satisfaction of deposit claims amount to $100,000, the $50,000 tax is collectible to the extent of the $25,000 excess of assets over deposit claims. Collection is not to be postponed until the full amount of the tax is collectible.

(b) *Depositors' claims against earnings.* Even though under a bona fide agreement a bank has been released from depositors' claims as to unsegregated assets, if all or a portion of its earnings are subject to depositors' claims, all assets the earnings from which, in whole or part, are charged with the payment of depositors' claims, will be immune from tax collection. But see § 39.3798-5 (a)

§ 39.3798-5 *Earnings*—(a) *Availability for tax collection.* Earnings of a bank within section 3798 (b), whether from segregated or unsegregated assets, which are necessary for, applicable to, and actually used for, payment of depositors' claims under an agreement, are within the immunity of the section. If only a portion or percentage of income from segregated or unsegregated assets is available and necessary for payment of depositors' claims, the remaining income is available for tax collection. Earnings of the bank's first fiscal year ending after the making of the agreement not applicable to payment of depositors will be assumed to be applicable for collection of any tax due prior or subsequent to execution of the agreement. Earnings of subsequent fiscal periods from unsegregated assets not applicable to depositors' claims will be assumed to be applicable to payment of taxes as to which immunity under the section has not previously attached. Earnings from segregated assets are available for collection of tax, whether previously uncollectible under the section or not, after depositors' claims against such assets have been paid in full. See §§ 39.3798-3 (a) and 39.3798-9 (a)

(b) *Tax computation.* The fact that earnings of a given year may be wholly or partly unavailable under section 3798 for collection of taxes does not exempt the income for that year, or any part thereof, from tax liability. The section affects collectibility only, and is not concerned with taxability. Accordingly, the taxpayer's income tax return shall correctly compute the tax liability, even though in the opinion of the taxpayer it is immune from tax collection under the section. The tax shall be determined with respect to the entire taxable income and not merely with respect to the portion of the earnings out of which tax may be collected. As to establishment of immunity from tax collection see § 39.3798-7.

Example. (1) An agreement, executed in the year 1952 between a bank and its depositors, provides (1) that certain assets are to be segregated for the benefit of the depositors who have waived (as claims against unsegregated assets of the bank) a percentage of their deposits; (2) that 40 percent of the bank's net earnings, for fiscal years beginning with the fiscal year ending December 31, 1952, from unsegregated assets, shall be paid to the depositors until the portion of their claims waived with respect to unsegregated assets of the bank has been paid; and (3) that the unsegregated assets shall not be subject to depositors' claims. The net income of the bank for the calendar year 1952 is $10,000, $4,000 produced by the segregated, and $6,000 produced by the unsegregated assets. Such amount shall be considered the net earnings for the purpose of section 3798 in computing the portion of the earnings to be paid to depositors. The bank has an outstanding tax liability for prior years of $7,000. The income tax liability of the bank for 1952 is 30 percent of $10,000, or $3,000, making a total outstanding tax liability of $10,000. The portion of the earnings of the bank for 1952 remaining after provision for depositors is $3,600 ($6,000 less 40 percent thereof, or $2,400). It will be assumed that of the total outstanding tax liability of $10,000, $3,600 may be assessed and collected, leaving $6,400 to be collected from any excess of the segregated assets after claims of depositors against such segregated assets have been paid in

full. No part of the $6,400 immune from collection from 1952 earnings may be collected thereafter from unsegregated assets of the bank or earnings therefrom, so that except for any possible surplus of the segregated assets the $6,400 is uncollectible.

(2) In the year 1953, the earnings are again $10,000, $4,000 from segregated and $6,000 from unsegregated assets, as in 1952. However, the return filed shows income of $5,000 and a tax liability of $1,500. An investigation shows the true income to be $10,000, on which the tax is $3,000. The full $3,000 will be assumed to be collectible. The $600 difference between $3,600 (the excess of earnings from unsegregated assets over the amount going to the depositors), and the $3,000 tax for 1953, is not available for collection of the tax for prior years, which became immune as described above, but may be available for collection of tax for subsequent years.

(c) No significance attaches to the selection of the years 1952 and 1953 in the example set forth in paragraph (b) of this section. The rules indicated by the example are equally applicable to subsequent or prior years not excluded by limitations.

§ 39.3798-6 *Abatement and refund.* (a) An assessment or collection, no matter when made, if contrary to section 3798, is subject to abatement or refund within the applicable statutory period of limitations.

(b) Collection from a bank within section 3798 (b) which diminished assets necessary for payment of depositors, if made prior to agreement with depositors, is not contrary to the section, and affords no ground for refund.

(c) Any abatement or refund is subject to existing statutory periods of limitation, which periods are not suspended or extended by section 3798. In order to secure refund of any taxes paid for any taxable year during the period of immunity the bank must file claim therefor.

§ 39.3798-7 *Establishment of immunity.* (a) The mere allegation of insolvency, or that depositors have claims against segregated or other assets or earnings, will not of itself secure immunity from tax collection. It must be affirmatively established to the satisfaction of the Commissioner that collection of tax will be contrary to section 3798. See also § 39.3798-8.

(b) Any claim, by a bank, of immunity under section 3798 (b) shall be supported by a statement, under oath or affirmation, which shall show: (1) The total of depositors' claims outstanding, and (2) separately and in detail, the amount of each of the following, and the amount of depositors' claims properly chargeable against each: (i) Segregated or transferred assets; (ii) unsegregated assets; (iii) estimated future average annual earnings and profits; (iv) amount collectible from shareholders; and (v) any other resources available for payment of depositors' claims. The detail shall show the full amount of depositors' claims chargeable against each of the items in subdivisions (i) to (v), inclusive, of this paragraph even though part or all of the amount chargeable against a particular item is also chargeable against some other item or items. There shall also be filed a copy of any agreement between the bank and its depositors, and any other agreement or document bearing on the claim of immunity. The statement shall show the basis, as "book," "market," etc., of valuation of the assets.

§ 39.3798-8 *Procedure during immunity—(a) Statements to be filed.* As long as complete or partial immunity is claimed, a bank within section 3798 (b) shall file with each income tax return a statement as required by § 39.3798-7, in duplicate, and shall also file such additional statements as the Commissioner may require. Whether or not additional statements shall be required, and the frequency thereof, will depend on the circumstances, including the financial status and apparent prospects of the bank, and the time which is available for assessment and collection. If a copy of an agreement or document has once been filed, a copy of the same agreement or document need not again be filed with a subsequent statement, if it is shown by the subsequent statement, when and where and with what return the copy was filed. In case of amendment a copy of the amendment must be filed with the return for the taxable year in which the amendment is made.

(b) *Failure to file.* Failure of a bank to file any required statement will be treated as indicating that the bank is not entitled to immunity.

§ 39.3798-9 *Termination of immunity—(a) In general.* (1) In the case of a bank within section 3798 (a), immunity will end whenever, and to the extent that, taxes may be assessed and collected, within the applicable limitation periods as extended by section 3798, without diminishing the assets available and necessary for payment of depositors. Immunity of a bank within section 3798 (b) is terminated, as to segregated assets, whenever claims of depositors against such assets have been paid in full. See § 39.3798-3. As to segregated assets, the termination of immunity is complete, and any balance remaining after payment of depositors is available, within statutory limitations, for collection of tax due at any time. However, taxes of the bank will be collectible from segregated assets only to the extent that the bank has a legal or equitable interest therein. Assets as to which there has been a complete conveyance for benefit of depositors, and the bank has bona fide been divested of all legal and equitable interest, are not available for collection of the bank's tax liability.

(2) As to unsegregated assets of a bank within section 3798 (b), immunity terminates only as to taxes thereafter becoming due. When taxes are once immune from collection, the immunity as to unsegregated assets is absolute. But see § 39.3798-4 (a).

(b) *General creditors.* While the immunity from tax collection is for protection of depositors, and not for benefit of general creditors, in some cases the immunity will not end until the assets are sufficient to cover indebtedness of creditors generally. This situation will exist where under applicable law the claims of general creditors are on a parity with those of depositors, so that to pay depositors in full it is necessary to pay all creditors in full.

(c) *Shareholder liability.* In determining the sufficiency of the assets to satisfy the depositors' claims, shareholders' liability to the extent collectible shall be treated as available assets. See § 39.3798-7.

(d) *Deposit insurance.* Deposit insurance payable to depositors shall not be treated as an asset of the bank and shall be disregarded in determining the sufficiency of the assets to meet the claims of depositors.

(e) *Notice by bank.* A bank within section 3798 (b) upon termination of immunity with respect to (1) earnings, (2) segregated or transferred assets, or (3) unsegregated assets, shall immediately notify the district director of internal revenue for the internal revenue district in which the taxpayer's returns were filed of such termination of immunity. See § 39.3798-8 (b).

(f) *Payment by bank.* As immunity terminates with respect to any assets, it will be the duty of the bank, without notice from the district director of internal revenue, to make payment of taxes collectible from such assets.

§ 39.3798-10 *Collection of tax after termination of immunity.* If, in the case of a bank within section 3798 (b) segregated assets (including earnings therefrom) in excess of those necessary for payment of outstanding deposits become available, such excess of segregated assets shall be applied toward satisfaction of accumulated outstanding taxes previously immune under the section, and not barred by the statute of limitations. But see § 39.3798-3. Where sufficient segregated or unsegregated assets are available, statutory interest shall be collected with the tax. When unsegregated assets or earnings therefrom previously immune become available for tax collection, they will be available only for collection of taxes (including interest and other additions) becoming due after immunity ceases. See the example in § 39.3798-5 (c).

§ 39.3798-11 *Social security taxes.* The regulations under section 3798 do not relate to social security taxes, since the immunity granted by the section does not apply to taxes imposed by the Social Security Act.

§ 39.3799-3800 *Statutory provisions; income from obligations and mortgages issued by joint-stock land banks; jurisdiction of District Courts to issue orders, processes, and judgments.*

SEC. 3799. *Income from obligations and mortgages issued by joint-stock land banks.* Notwithstanding the provisions of section 26 of the Federal Farm Loan Act, 39 Stat. 380 (U. S. C., Title 12, section 931-3), as amended, in the case of mortgages made or obligations issued by any joint-stock land bank after May 28, 1938, all income, except interest, derived therefrom shall be included in gross income and shall not be exempt from Federal income taxation.

SEC. 3800. *Jurisdiction of district courts to issue orders, processes, and judgments.* The district courts of the United States at the

instance of the United States shall have such jurisdiction to make and issue, both in actions at law and suits in equity, writs and orders of injunction, and of ne exeat republica, orders appointing receivers, and such other orders and process, and to render such judgments and decrees, granting in proper cases both legal and equitable relief together, as may be necessary or appropriate for the enforcement of the internal revenue laws. The remedies hereby provided are in addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such laws.

§ 39.3801 (a) (1) *Statutory provisions; mitigation of effect of limitation and other provisions in income tax cases; definition of determination.*

SEC. 3801. *Mitigation of effect of limitation and other provisions in income tax cases*—(a) *Definitions.* For the purpose of this section—

(1) *Determination.* The term "determination under the income tax laws" means—

(A) A closing agreement made under section 3760:

(B) A decision by the Board of Tax Appeals or a judgment, decree, or other order by any court of competent jurisdiction, which has become final; or

(C) A final disposition by the Commissioner of a claim for refund. For the purposes of this section a claim for refund shall be deemed finally disposed of by the Commissioner—

(i) As to items with respect to which the claim was allowed, upon the date of allowance of refund or credit or upon the date of mailing notice of disallowance (by reason of offsetting items) of the claim for refund, and

(ii) As to items with respect to which the claim was disallowed, in whole or in part, or as to items applied by the Commissioner in reduction of the refund or credit, upon expiration of the time for instituting suit with respect thereto (unless suit is instituted prior to the expiration of such time).

Such term shall not include any such agreement made, or decision, judgment, decree, or order which became final, or claim for refund finally disposed of, prior to August 27, 1938.

§ 39.3801 (a) (1)-1 *Purpose and scope of section 3801.* Section 3801 provides for correction of the effect of certain types of errors specified in section 3801 (b) and §§ 39.3801 (b)-1 to 39.3801 (b)-5, inclusive, when one or more provisions of the internal revenue laws, such as the statute of limitations, would otherwise prevent such correction. Corrections are authorized under section 3801 only when the Commissioner, if the correction would result in an allowance of a refund or credit for the year with respect to which the error was made, or the taxpayer, if the correction would result in an additional assessment for such year, has maintained a position inconsistent with the error. No correction is permissible unless the inconsistent position is adopted by a determination made on or after August 27, 1938. The provisions of section 3801 and of the regulations promulgated under such section shall not apply to any tax imposed by chapter 9, relating to employment taxes.

§ 39.3801 (a) (1)-2 *Closing agreement as a determination.* For the purposes of section 3801, a determination may take the form of a closing agreement authorized by section 3760. Such an agreement may relate to the total tax liability of the taxpayer for a particular taxable year or years or to one or more separate items affecting such liability. If it becomes necessary or desirable to effect a determination in order to obtain or accelerate an adjustment authorized by section 3801, a closing agreement may be used for such purpose whenever a taxpayer and the Government have concurred in the disposition of an item or items. A closing agreement becomes final within the meaning of section 3801 on the date of its approval by the Secretary, the Under Secretary, or an Assistant Secretary, except that a closing agreement with respect to a final determination of tax liability for past years becomes final on the date of its approval by the Commissioner.

§ 39.3801 (a) (1)-3 *Decision by Tax Court or court as a determination.* (a) A determination may take the form of a decision by The Tax Court of the United States or a judgment, decree, or other order by any court of competent jurisdiction, which has become final.

(b) The date upon which a decision by the Tax Court becomes final is prescribed in section 1140.

(c) 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.

§ 39.3801 (a) (1)-4 *Final disposition of claim for refund as a determination.* (a) A determination may take the form of a final disposition of a claim for refund. Such disposition may result in a determination with respect to two classes of items, i. e., items included by the taxpayer in a claim for refund and items applied by the Commissioner to offset the alleged overpayment. The time at which a dispositon in respect of a particular item becomes final may depend not only upon what action is taken with respect to that item but also upon whether the claim for refund is allowed or disallowed.

(b) *Items with respect to which the taxpayer's claim is allowed.* (1) The disposition with respect to an item as to which the taxpayer's contention in the claim for refund is sustained becomes final on the date of allowance of the refund or credit if—

(i) The taxpayer's claim for refund is unqualifiedly allowed; or

(ii) The taxpayer's contention with respect to an item is sustained and with respect to other items is denied, so that the net result is an allowance of refund or credit; or

(iii) The taxpayer's contention with respect to an item is sustained, but the Commissioner applies other items to offset the amount of the alleged overpayment and the items so applied do not completely offset such amount but merely reduce it so that the net result is an allowance of refund or credit.

(2) If the taxpayer's contention in the claim for refund with respect to an item is sustained but the Commissioner applies other items to offset the amount of the alleged overpayment so that the net result is a disallowance of the claim for refund, the date of mailing, by registered mail, of the notice of disallowance (see section 3772) is the date of the final disposition as to the item with respect to which the taxpayer's contention is sustained.

(c) *Items with respect to which the taxpayer's claim is disallowed.* The disposition with respect to an item as to which the taxpayer's contention in the claim for refund is denied becomes final upon the expiration of the time allowed by section 3772 for instituting suit on the claim for refund, unless suit is instituted prior to the expiration of such period, if—

(1) The taxpayer's claim for refund is unqualifiedly disallowed, or

(2) The taxpayer's contention with respect to an item is denied and with respect to other items is sustained so that the net result is an allowance of refund or credit; or

(3) The taxpayer's contention with respect to an item is sustained in part and denied in part. For example, if the taxpayer claims a deductible loss of $10,000 and a consequent overpayment of $2,500 and the Commissioner concedes that a deductible loss was sustained but in the amount of $5,000 only, or that a deductible loss of $10,000 was sustained, but under the Commissioner's computation the consequent ovepayment is only $2,000, the disposition of the claim for refund with respect to both the allowance of the $5,000 and the disallowance of the remaining $5,000, or the allowance of the $2,000 overpayment and the denial of the $500, becomes final upon the expiration of the time for instituting suit on the claim for refund unless suit is instituted prior to the expiration of such period.

(d) *Items applied by the Commissioner in reduction of the refund or credit.* If the Commissioner applies an item in reduction of the overpayment alleged in the claim for refund, and the net result is an allowance of refund or credit, the disposition with respect to the item so applied by the Commissioner becomes final upon the expiration of the time allowed by section 3772 for instituting suit on the claim for refund, unless suit is instituted prior to the expiration of such period. If such application of the item results in the assertion of a deficiency, such action does not constitute a final disposition by the Commissioner of a claim for refund within the meaning of section 3801 (a) (1) (C) (ii), but subsequent action taken with respect to such deficiency may result in a determination under section 3801 (a) (1) (A) or (B)

(e) The necessity of waiting for the expiration of the 2-year period of limitations provided in section 3772 may be avoided in such cases as are described under paragraph (c) or (d) of this sec-

tion by the use of a closing agreement to effect a determination.

§ 39.3801 (a) (2)-(3) *Statutory provisions; mitigation of effect of limitation and other provisions in income tax cases; definitions of taxpayer and related taxpayer*

SEC. 3801. *Mitigation of effect of limitation and other provisions in income tax cases*—(a) *Definitions.* For the purpose of this section * * *

(2) *Taxpayer.* Notwithstanding the provisions of section 3797 the term "taxpayer" means any person subject to a tax under the applicable Revenue Act.

(3) *Related taxpayer.* The term "related taxpayer" means a taxpayer who, with the taxpayer with respect to whom a determination specified in subsection (b) (1), (2), (3), or (4) is made, stood, in the taxable year with respect to which the erroneous inclusion, exclusion, omission, allowance, or disallowance therein referred to was made, in one of the following relationships: (A) Husband and wife; (B) grantor and fiduciary; (C) grantor and beneficiary; (D) fiduciary and beneficiary, legatee, or heir; (E) decedent and decedent's estate; or (F) partner.

§ 39.3801 (a) (3)-1 *Related taxpayer* An adjustment in the case of the taxpayer with respect to whom the error was made may be authorized under section 3801 although the determination is made with respect to a different taxpayer, provided that such taxpayers stand in one of the relationships specified in section 3801 (a) (3) The concept of "related taxpayer" has application only to section 3801 (b) (1) (2) (3) or (4) and does not apply to section 3801 (b) (5) If such relationship exists, it is not essential that the error be with respect to a transaction possible only by reason of the existence of the relationship. For example, if the error with respect to which an adjustment is sought under section 3801 grew out of an assignment of rents between taxpayer A and taxpayer B, who are partners, and the determination is with respect to taxpayer A, an adjustment with respect to taxpayer B may be permissible despite the fact that the assignment had nothing to do with the business of the partnership. The relationship need not exist throughout the entire taxable year with respect to which the error was made, but only at some time during that taxable year. For example, if a taxpayer on February 15 assigns to his fiancee the net rents of a building which the taxpayer owns, and the two are married before the end of the taxable year, an adjustment may be permissible if the determination relates to such rents despite the fact that they were not husband and wife at the time of the assignment. See § 39.3801 (b)-8 for the requirement in certain cases that the relationship exist at the time an inconsistent position is first maintained.

§ 39.3801 (b) *Statutory provisions; mitigation of effect of limitation and other provisions in income tax cases; circumstances of adjustment.*

SEC. 3801. *Mitigation of effect of limitation and other provisions in income tax cases.* * * *

(b) *Circumstances of adjustment.* When a determination under the income tax laws—

(1) Requires the inclusion in gross income of an item which was erroneously included in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer; or

(2) Allows a deduction or credit which was erroneously allowed to the taxpayer for another taxable year or to a related taxpayer; or

(3) Requires the exclusion from gross income of an item with respect to which tax was paid and which was erroneously excluded or omitted from the gross income of the taxpayer for another taxable year or from the gross income of a related taxpayer; or

(4) Allows or disallows any of the additional deductions allowable in computing the net income of estates or trusts, or requires or denies any of the inclusions in the computation of net income of beneficiaries, heirs, or legatees, specified in section 162 (b) and (c) of chapter 1, and corresponding sections of prior revenue Acts, and the correlative inclusion or deduction, as the case may be, has been erroneously excluded, omitted, or included, or disallowed, omitted, or allowed, as the case may be, in respect of the related taxpayer; or

(5) Determines the basis of property for depletion, exhaustion, wear and tear, or obsolescence, or for gain or loss on a sale or exchange, and in respect of any transaction upon which such basis depends there was an erroneous inclusion in or omission from the gross income of, or an erroneous recognition or nonrecognition of gain or loss to, the taxpayer or any person who acquired title to such property in such transaction and from whom mediately or immediately the taxpayer derived title subsequent to such transaction—

and, on the date the determination becomes final, correction of the effect of the error is prevented by the operation (whether before, on or after May 28, 1938) of any provision of the internal-revenue laws other than this section and other than section 3761 (relating to compromises), then the effect of the error shall be corrected by an adjustment made under this section. Such adjustment shall be made only if there is adopted in the determination a position maintained by the Commissioner (in case the amount of the adjustment would be refunded or credited in the same manner as an overpayment under subsection (c)) or by the taxpayer with respect to whom the determination is made (in case the amount of the adjustment would be assessed and collected in the same manner as a deficiency under subsection (c)), which position is inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be. In case the amount of the adjustment would be assessed and collected in the same manner as a deficiency, the adjustment shall not be made with respect to a related taxpayer unless he stands in such relationship to the taxpayer at the time the latter first maintains the inconsistent position in a return, claim for refund, or petition (or amended petition) to the Board of Tax Appeals for the taxable year with respect to which the determination is made, or if such position is not so maintained, then at the time of the determination.

§ 39.3801 (b)-0 *Circumstances of adjustment.* (a) Section 3801 may be applied to correct the effect of an error if, on the date of the determination, correction of the effect of the error is prevented by the operation of any provision of the internal revenue laws other than section 3801 and other than section 3761 of the Internal Revenue Code and the corresponding provisions of prior revenue acts (relating to compromises) Examples of such provisions are: Sections 275, 311 (b) and (c) 322 (b) and (d) 1117 (e), 3746, and 3772 of the Internal Revenue Code and the corresponding provisions of prior revenue acts (relating to periods of limitation) sections 272 (f) and 322 (c) of the Internal Revenue Code and the corresponding provisions of prior revenue acts (relating to effect of petition to The Tax Court of the United States on further deficiency letters and on credits or refunds) section 3760 of the Internal Revenue Code and the corresponding provisions of prior revenue acts (relating to closing agreements) and sections 3770 (a) (2) 3774, and 3775 of the Internal Revenue Code and the corresponding provisions of prior revenue acts (relating to payments, refunds, or credits after the period of limitation has expired)

(b) If the tax liability for the year with respect to which the error was made has been compromised under section 3761 of the Internal Revenue Code or the corresponding provisions of prior revenue acts, no adjustment may be made under section 3801 with respect to that year.

(c) Section 3801 is not applicable if, on the date of the determination, correction of the effect of the error is permissible without recourse to such section.

(d) The determination may be with respect to the tax imposed by chapter 1 and subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code, by the corresponding provisions of any prior revenue acts, or by more than one of such provisions. Section 3801 may be applied to correct the effect of the error only as to the tax or taxes for the year with respect to which the error was made which correspond to the tax or taxes to which the determination relates. Thus, if the determination relates to the tax imposed by chapter 1 of the Internal Revenue Code, the adjustment may be only with respect to the tax imposed by such chapter or by the corresponding provisions of the revenue act applicable to the year with respect to which the error was made; if the determination relates to subchapter B of chapter 2 of the Internal Revenue Code, the adjustment may be only with respect to the tax imposed by such subchapter or by the corresponding provisions of the revenue act applicable to the year with respect to which the error was made.

§ 39.3801 (b)-1 *Double inclusion of item of gross income.* (a) Section 3801 (b) (1) applies if the determination requires the inclusion, in a taxpayer's gross income, of an item which was erroneously included in the gross income of the same taxpayer for another taxable year or of a related taxpayer for the same or another taxable year.

(b) The application of section 3801 (b) (1) may be illustrated by the following examples:

Example (1). A taxpayer who keeps his books on the cash basis erroneously included in his return for 1944 an item of accrued rent. In 1949, after the period of limitations on refunds for 1944 has expired,

the Commissioner discovers that the taxpayer received this rent in 1945 and asserts a deficiency for the year 1945, which is sustained by The Tax Court of the United States in 1952. An adjustment is authorized with respect to the year 1944. If the taxpayer had returned the rent for both 1944 and 1945 and by a determination was denied a refund claimed for 1945 on account of the rent item, a similar adjustment is authorized.

Example (2). A husband assigned to his wife salary to be earned by him in the year 1950. The wife included such salary in her separate return for that year and the husband omitted it. The Commissioner asserted a deficiency against the wife for 1950 with respect to a different item and she contested that deficiency before the Tax Court. The wife would therefore be barred by section 322 (c) from filing a claim for refund for 1950. Thereafter, the Commissioner asserts a deficiency against the husband on account of the omission of such salary from his return for 1950. The husband unsuccessfully contests the deficiency before the Tax Court in 1952. An adjustment is authorized with respect to the wife's tax for 1950.

§ 39.3801 (b)-2 *Double allowance of a deduction or credit.* (a) Section 3801 (b) (2) applies if the determination allows the taxpayer a deduction or credit which was erroneously allowed the same taxpayer for another taxable year or a related taxpayer for the same or another taxable year.

(b) The application of section 3801 (b) (2) may be illustrated by the following examples:

Example (1). A taxpayer in his return for 1947 claimed and was allowed a deduction for destruction of timber by a forest fire. Subsequently it was discovered that the forest fire occurred in 1948 rather than in 1947. After the expiration of the period of limitations for the assessment of a deficiency for 1947, the taxpayer files a claim for refund for 1948 based upon a deduction for the fire loss in that year. The Commissioner in 1952 allows the claim for refund. An adjustment is authorized with respect to the year 1947.

Example (2). The beneficiary of a testamentary trust in his return for 1946 claimed, and was allowed, a deduction for depreciation of the trust property. The Commissioner asserted a deficiency against the beneficiary for 1946 with respect to a different item and final decision of The Tax Court of the United States was rendered in 1948, so that the Commissioner was thereafter barred by section 272 (f) of the Internal Revenue Code from asserting a further deficiency against the beneficiary for 1946. The trustee thereafter filed a timely refund claim contending that, under the terms of the will, the trust, and not the beneficiary, was entitled to the allowance for depreciation. The court in 1952 sustains the refund claim. An adjustment is authorized with respect to the beneficiary's tax for 1946.

§ 39.3801 (b)-3 *Erroneous exclusion of item of gross income with respect to which tax was paid.* (a) Section 3801 (b) (3) applies if the determination requires the exclusion, from a taxpayer's gross income, of an item with respect to which tax was paid and which was erroneously excluded or omitted from the gross income of the same taxpayer for another taxable year or of a related taxpayer for the same or another taxable year.

(b) The application of section 3801 (b) (3) may be illustrated by the following examples:

Example (1). A taxpayer received payments in 1949 under a contract for the performance of services and included the payments in his return for that year. A closing agreement was thereafter made with respect to the tax liability of the taxpayer for 1948. The taxpayer subsequently filed a claim for refund for the year 1949, asserting that he kept his books on the accrual basis and that, as the payments had accrued in 1948, they were properly taxable in that year. The claim for refund is allowed in 1952. An adjustment is authorized with respect to the year 1948. If the taxpayer had not included the payments in any return and the Commissioner had asserted a deficiency for 1949 with respect to the payments, and the deficiency was not sustained by The Tax Court of the United States in its final decision in 1953, no adjustment is authorized with respect to the year 1948. Although the determination requires the exclusion of the item from gross income, no tax had been paid with respect thereto. If the taxpayer, however, had paid the deficiency and thereafter successfully sued for refund in court, an adjustment is authorized.

Example (2). A father and son conducted a partnership business, each being entitled to one-half of the net profits. The father included the entire net income of the partnership in his return for 1945, and the son included no portion of this income in his return for that year. Shortly before the expiration of the period of limitations with respect to deficiency assessments and refund claims for both father and son for 1945, the father filed a claim for refund of that portion of his 1945 tax attributable to the half of the partnership income which should have been included in the son's return. The court sustains the claim for refund in 1952. An adjustment is authorized with respect to the son's tax for 1945.

§ 39.3801 (b)-4 *Correlative deductions and inclusions specified in section 162 (b) and (c) and corresponding provisions of prior revenue acts.* (a) Section 3801 (b) (4) applies if the determination relates to the additional deduction specified in section 162 (b) and (c) of the Internal Revenue Code, or the corresponding provisions of a prior revenue act, for amounts distributable to the beneficiaries, heirs, or legatees of an estate or trust, and such determination requires:

(1) The allowance to the estate or trust of such additional deduction when such amounts have been erroneously omitted or excluded from the income of the beneficiaries, heirs, or legatees;

(2) The inclusion of such amounts in the income of the beneficiaries, heirs, or legatees when such additional deduction has been erroneously disallowed to or omitted by the estate or trust;

(3) The disallowance to an estate or trust of such additional deduction when such amounts have been erroneously included in the income of the beneficiaries, heirs, or legatees; or

(4) The exclusion of such amounts from the income of the beneficiaries, heirs, or legatees when such additional deduction has been erroneously allowed to the estate or trust.

(b) The application of paragraph (a) (1) of this section may be illustrated by the following example:

Example. For the taxable year 1946, a trustee, directed by the trust instrument to accumulate the trust income, made no distribution to the beneficiary and returned the entire net income as taxable to the trust. Accordingly, the beneficiary did not include the trust income in his return for the year 1946. In 1948, a State court held invalid the clause directing accumulation. In 1950, the trustee, relying upon the court decision, files a claim for refund of the tax paid on behalf of the trust for the year 1946. The claim is sustained by the court in 1952 after the expiration of the period of limitations upon deficiency assessments against the beneficiary for the year 1946. An adjustment is authorized with respect to the beneficiary's tax for the year 1946.

(c) The application of paragraph (a) (2) of this section may be illustrated by the following example:

Example. Assume the same facts as in the example in paragraph (b) of this section, except that, instead of the trustee's filing a refund claim, the Commissioner, relying upon the decision of the State court, asserts a deficiency against the beneficiary for 1946. The deficiency is sustained by final decision of The Tax Court of the United States in 1952, after the expiration of the period for filing claim for refund on behalf of the trust for 1946. An adjustment is authorized with respect to the trust for the year 1946.

(d) The application of paragraph (a) (3) of this section may be illustrated by the following example:

Example. A trustee claimed in the return for 1946 a deduction for income distributed to the beneficiary. The income was included by the beneficiary in his return for 1946. In 1950, the Commissioner asserts a deficiency against the trust on the ground that the amount distributed to the beneficiary represented a charge against the corpus of the trust and did not constitute a distribution of income. The deficiency is sustained by final decision of the Tax Court in 1952, after the expiration of the period for filing claims for refund by the beneficiary for 1946. An adjustment is authorized with respect to the beneficiary's tax for the year 1946.

(e) The application of paragraph (a) (4) of this section may be illustrated by the following example:

Example. Assume the same facts as in the example in paragraph (d) of this section, except that, instead of the Commissioner's asserting a deficiency, the beneficiary files a refund claim for 1946 on the same ground. The claim is sustained by the court in 1952 after the expiration of the period of limitations upon deficiency assessments against the trust for 1946. An adjustment is authorized with respect to the trust for the year 1946.

§ 39.3801 (b)-5 *Determination of basis of property in case of erroneous treatment of transaction relating to acquisition thereof.* (a) Section 3801 (b) (5) applies if the determination establishes the basis of property for income tax purposes and in respect of the transaction upon which such basis depends there was an erroneous inclusion in or omission from gross income or an erroneous recognition or nonrecognition of gain or loss with respect to (1) the taxpayer with respect to whom the determination is made, or (2) any person who acquired title to such property in such transaction and the taxpayer with respect to whom the determination is

made mediately or immediately derived title from such person subsequent to such transaction. Section 3801 (b) (5) applies with respect to the person who acquired the property and any subsequent transferees or donees who have a substituted basis ascertained by reference to the basis in the hands of such person. No adjustment is authorized with respect to the transferor of the property in the transaction upon which the basis of the property depends, when the determination is with respect to the original transferee or a subsequent transferee of such original transferee.

(b) The application of section 3801 (b) (5) may be illustrated by the following examples:

Example (1). In 1946 taxpayer A transferred property which had cost him $5,000 to the X Corporation in exchange for an original issue of shares of its stock having a fair market value of $10,000. In his return for 1946 taxpayer A treated the exchange as one in which gain or loss was not recognizable:

(i) In 1952 the X Corporation claims that gain should have been recognized on the exchange in 1946 and therefore the property it received had a $10,000 basis for depreciation. Its contention is confirmed by a closing agreement. No adjustment is authorized with respect to the tax of the X Corporation for 1946, as there was no "erroneous inclusion in or omission from the gross income of, or an erroneous recognition or nonrecognition of gain or loss to" the X Corporation with respect to the exchange in 1946. Moreover no adjustment is authorized with respect to taxpayer A, as he is not the taxpayer with respect to whom the determination is made, nor does the determination relate to the property which taxpayer A acquired in the exchange in 1946, but, rather, to the property which he transferred in such exchange.

(ii) In 1952 the X Corporation transfers the property to the Y Corporation in a tax-free exchange. In 1953 the Y Corporation sells the property and computes its profit on the basis of $10,000, which basis is sustained by The Tax Court of the United States. No adjustment is authorized with respect to the Y Corporation or with respect to taxpayer A, for the reason stated in (i).

(iii) In 1954 taxpayer A sells the stock which he had received in 1946 and claims that, as gain should have been recognized on the exchange in 1946 the basis for computing the profit on the sale is $10,000. His contention is confirmed in a closing agreement. An adjustment is authorized with respect to his tax for the year 1946, as the basis for computing gain on the sale depends upon the transaction in 1946 and in respect of that transaction there was an erroneous nonrecognition of gain to taxpayer A, "the taxpayer" with respect to whom the determination is made.

(iv) Taxpayer A does not sell the stock, but makes a gift of it to taxpayer B, who later sells the stock and claims the $10,000 basis, which contention is confirmed in a closing agreement. An adjustment is authorized with respect to the tax of taxpayer A for 1946, as the basis for computing gain on the sale by taxpayer B depends upon the transaction in 1946 and in respect of that transaction there was erroneous nonrecognition of gain to taxpayer A, the "person who acquired title to such property in such transaction and from whom * * * immediately" taxpayer B, with respect to whom the determination is made, "derived title subsequent to such transaction."

Example (2). In 1947, taxpayer A sold property acquired at a cost of $5,000 to taxpayer B for $10,000. In his return for 1947 taxpayer A failed to include the profit on such sale. In 1952 taxpayer B sells the property for $12,000 and in his return for 1952 reports a gain of $2,000 upon the sale, which is confirmed in a closing agreement. No adjustment is authorized with respect to the tax of taxpayer A for 1947, as taxpayer A is not the taxpayer with respect to whom the determination is made; nor does the determination relate to property which taxpayer A acquired in the transaction in 1947 but rather to property which he transferred in such transaction.

Example (3). In 1946 a taxpayer received as additional compensation shares of stock in a corporation but did not include any amount in his return for that year on account of the receipt of such stock. In 1952, after the expiration of the period of limitations on deficiency assessments for 1946, he sells the stock for $15,000 and reports $5,000 in his return for 1952 as profit on the sale. A deficiency is asserted by the Commissioner on the theory that the basis is zero and the recognized gain is $15,000. The Tax Court sustains the taxpayer's contention that the transaction was erroneously treated in 1946 in that the property then had a fair market value of $10,000. An adjustment is authorized with respect to the year 1946.

Example (4). In 1943 a taxpayer received 100 shares of stock of the X Corporation having a fair market value of $5,000, in exchange for shares of stock in the Y Corporation which he had acquired at a cost of $12,000. In his return for 1943 the taxpayer treated the exchange as one in which gain or loss was not recognizable. The taxpayer sold 50 shares of the X Corporation stock in 1944 and in his return for that year treated such shares as having a $6,000 basis. In 1949 the taxpayer sells the remaining 50 shares of stock of the X Corporation for $7,500 and reports $1,500 gain in his return for 1949. After the expiration of the period of limitations on deficiency assessments and on refund claims for 1943 and 1944, the Commissioner asserts a deficiency for 1949 on the ground that the loss realized on the exchange in 1943 was erroneously treated as nonrecognizable, and that the basis for computing gain upon the sale in 1949 is $2,500, resulting in a gain of $5,000. The deficiency is sustained by the Tax Court in 1953. An adjustment is authorized with respect to the year 1943 as to the entire $7,000 loss realized on the exchange. No adjustment is authorized with respect to the year 1944 as the basis for computing gain upon the sale of the 50 shares in 1949 does not depend upon the transaction in 1944.

§ 39.3801 (b)-6 *Law applicable in determination of error.* The question whether there was an erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition is determined under the provisions of the internal revenue laws applicable with respect to the year as to which the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, was made. The fact that the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, was in pursuance of an interpretation, either judicial or administrative, accorded such provisions of the internal revenue laws at the time of such action is not necessarily determinative of this question. For example, if a later judicial decision authoritatively alters such interpretation so that such action was contrary to such provisions of the internal revenue laws as later interpreted, the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, is erroneous within the meaning of section 3801.

§ 39.3801 (b)-7 *Operation dependent upon maintenance of inconsistent position*—(a) *Adjustments resulting in additional assessments.* (1) An adjustment which would result in an additional assessment is authorized only if (i) the taxpayer, with respect to whom the determination is made, has, in connection therewith, maintained a position which is inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, and (ii) such inconsistent position is adopted in the determination.

Example. A taxpayer in his return for 1947 claimed and was allowed a deduction for a loss arising from a casualty. After the taxpayer had filed his return for 1948 and after the period of limitations upon the assessment of a deficiency for 1947 had expired, it was discovered that the loss actually occurred in 1948. The taxpayer, therefore, filed a claim for refund for the year 1948 based upon the allowance of a deduction for the loss in that year, and the claim was allowed by the Commissioner in 1952. The taxpayer thus has maintained a position inconsistent with the allowance of the deduction for 1947 by filing a claim for refund for 1948 based upon the same deduction. As the determination—the allowance by the Commissioner of the claim for refund—adopts such inconsistent position, an adjustment is authorized for the year 1947.

(2) An adjustment which would result in an additional assessment is not authorized if the Commissioner, and not the taxpayer, has maintained such inconsistent position.

Example. In the example in subparagraph (1) of this paragraph, assume that the taxpayer did not file a claim for refund for 1948 but the Commissioner issued a notice of deficiency for 1948 based upon other items. The taxpayer filed a petition with The Tax Court of the United States and the Commissioner in his answer voluntarily proposed the allowance of a deduction for the loss previously allowed for 1947. The Tax Court took the deduction into account in its redetermination in 1952 of the tax for the year 1948. In such case no adjustment would be authorized for the year 1947 as the Commissioner, and not the taxpayer, has maintained a position inconsistent with the allowance of a deduction for the loss in that year.

(b) *Adjustments resulting in refund or credit.* (1) An adjustment which would result in the allowance of a refund or credit is authorized only if (i) the Commissioner, in connection with a determination, has maintained a position which is inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, and (ii) such inconsistent position is adopted in the determination.

Example. A taxpayer who keeps his books on the cash basis erroneously included in his return for 1946 an item of accrued interest. After the period of limitations on refunds for 1946 had expired, the Commissioner asserted a deficiency for the year 1947 on the ground that the item of interest was

received in 1947, and, therefore, was properly includible in gross income for that year. The taxpayer appealed to the Tax Court which in 1952 sustained the deficiency. By asserting a deficiency for 1947 based upon the inclusion of the interest item in that year, the Commissioner has maintained a position inconsistent with the inclusion of the interest item in 1946. As the determination—the decision of the Tax Court sustaining the deficiency—adopted such inconsistent position, an adjustment is authorized for the year 1946.

(2) An adjustment which would result in the allowance of a refund or credit is not authorized if the taxpayer with respect to whom the determination is made, and not the Commissioner, has maintained such inconsistent position.

Example. In the example in subparagraph (1) of this paragraph, assume that the Commissioner asserted a deficiency for 1947 based upon other items for that year, but in computing the net income upon which such deficiency was based did not include the item of interest. The taxpayer appealed to the Tax Court and in his petition asserted that the interest item should be included in gross income for 1947. The Tax Court in 1952 included the item of interest in its redetermination of the tax for the year 1947. In such case no adjustment would be authorized for 1946 as the taxpayer, and not the Commissioner, has maintained a position inconsistent with the erroneous inclusion of the item of interest in the gross income of the taxpayer for that year.

§ 39.3801 (b)-8 *Existence of status of related taxpayer at time of the first maintenance of an inconsistent position.* (a) No adjustment by way of a deficiency assessment shall be made with respect to a related taxpayer unless the relationship existed both in the taxable year with respect to which the error was made and at the time the taxpayer with respect to whom the determination is made first maintained, in the manner described in this section, the inconsistent position with respect to the taxable year to which the determination relates.

(b) If the inconsistent position is maintained in a return, claim for refund, or petition (or amended petition) to The Tax Court of the United States for the taxable year in respect of which the determination is made, the requisite relationship must exist on the date of filing such document. If the inconsistent position is maintained in more than one of such documents, the requisite date is the date of filing of the document in which it was first maintained. If the inconsistent position was not thus maintained then the relationship must exist on the date of the determination, as, for example, where at the instance of the taxpayer a deduction is allowed, the right to which was not asserted in a return, claim for refund, or petition to The Tax Court, and a determination is effected by means of a closing agreement.

§ 39.3801 (c) *Statutory provisions; mitigation of effect of limitation and other provisions in income tax cases; method of adjustment.*

SEC. 3801. *Mitigation of effect of limitation and other provisions in income tax cases.* * * *

(c) *Method of adjustment.* The adjustment authorized in subsection (b) shall be made by assessing and collecting, or refunding or crediting, the amount thereof, to be ascertained as provided in subsection (d), in the same manner as if it were a deficiency determined by the Commissioner with respect to the taxpayer as to whom the error was made or an overpayment claimed by such taxpayer, as the case may be, for the taxable year with respect to which the error was made, and as if on the date of the determination specified in subsection (b) one year remained before the expiration of the periods of limitation upon assessment or filing claim for refund for such taxable year.

§ 39.3801 (c)-1 *Method of adjustment.* (a) If the amount of the adjustment ascertained pursuant to section 3801 (d) represents an increase in tax, it is to be treated as if it were a deficiency determined by the Commissioner with respect to the taxpayer as to whom the error was made and for the taxable year with respect to which the error was made. The amount of the adjustment is thus to be assessed and collected under the law and regulations applicable to the assessment and collection of deficiencies, subject, however, to the limitations imposed by section 3801 (e) Notice of deficiency, unless waived, must be issued with respect to such amount and the taxpayer may contest the deficiency before The Tax Court of the United States or, if he chooses, may pay the deficiency and later file claim for refund. If the amount of the adjustment ascertained pursuant to section 3801 (d) represents a decrease in tax, it is to be treated as if it were an overpayment claimed by the taxpayer with respect to whom the error was made for the taxable year with respect to which the error was made. Such amount may be recovered under the law and regulations applicable to overpayments of tax, subject, however, to the limitations imposed by section 3801 (e) The taxpayer must file a claim for refund thereof, unless the overpayment is refunded without such claim, and if the claim is denied or not acted upon by the Commissioner within the prescribed time, the taxpayer may then file suit for refund. The amount of the adjustment treated as if it were a deficiency or an overpayment, as the case may be, will bear interest and be subject to additions to the tax to the extent provided by the internal revenue laws applicable to deficiencies and overpayments for the taxable year with respect to which the error was made.

(b) For the purpose of the adjustment authorized by section 3801, the period of limitation upon the making of an assessment or upon refund or credit for the taxable year with respect to which the error was made, as the case may be, shall be considered as if, on the date of the determination, one year remained before the expiration of such period, regardless of whether or not such period had expired prior to the date of the determination. The Commissioner thus has one year from the date of the determination within which to mail a notice of deficiency in respect of the amount of the adjustment where such amount is treated as if it were a deficiency. The issuance of such notice of deficiency, in accordance with the law and regulations applicable to the assessment of deficiencies, will suspend the running of the 1-year period of limitations provided by section 3801 (c) In accordance with the applicable law and regulations governing the collection of deficiencies (see section 276 (c) of the Internal Revenue Code and the corresponding provisions of prior revenue acts) the period of limitation for collection of the amount of the adjustment will commence to run from the date of assessment of such amount. Similarly the taxpayer has a period of one year from the date of the determination within which to file a claim for refund in respect of the amount of the adjustment where such adjustment is treated as if it were an overpayment. Where the amount of the adjustment is treated as if it were a deficiency and the taxpayer chooses to pay such deficiency and contest it by way of claim for refund, the period of limitation upon filing claim for refund will commence to run from the date of such payment (see section 322 (b) of the Internal Revenue Code and the corresponding provisions of prior revenue acts)

§ 39.3801 (d) *Statutory provisions; mitigation of effect of limitation and other provisions in income tax cases; ascertainment of amount of adjustment.*

SEC. 3801. *Mitigation of effect of limitation and other provisions in income tax cases.* * * *

(d) *Ascertainment of amount of adjustment.* In computing the amount of an adjustment under this section there shall first be ascertained the tax previously determined for the taxable year with respect to which the error was made. The amount of the tax previously determined shall be the excess of—

(1) The sum of (A) the amount shown as the tax by the taxpayer upon his return (determined as provided in section 271 (b) (1) and (3)), if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over—

(2) The amount of rebates, as defined in section 271 (b) (2), made.

There shall then be ascertained the increase or decrease in the tax previously determined which results solely from the correct exclusion, inclusion, allowance, disallowance, recognition, or nonrecognition, of the item, inclusion, deduction, credit, gain or loss, which was the subject of the error. The amount so ascertained (together with any amounts wrongfully collected, as additions to the tax or interest, as a result of such error) shall be the amount of the adjustment under this section.

[Sec. 3801 (d) as amended by sec. 14 (b), Individual Income Tax Act 1944]

§ 39.3801 (d)-1 *Ascertainment of amount of adjustment.* (a) In computing the amount of the adjustment under section 3801 there must first be ascertained the amount of the tax previously determined for the taxpayer as to whom the error was made for the taxable year with respect to which the error was made. The tax previously determined for any taxable year may be the amount of tax shown on the taxpayer's return, but if any changes in that amount have been made they must be taken into

account. In such cases, the tax previously determined will be ascertained as follows:

(1) For taxable years beginning before January 1, 1943, the tax previously determined will be the tax shown on the return, increased by any amounts previously assessed (or collected without assessment) as deficiencies, and decreased by any amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax. If no amount was shown as the tax upon the return, or if no return was made, the tax previously determined will be the sum of the amounts previously assessed, or collected without assessment, as deficiencies, decreased by any amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax.

(2) For taxable years beginning after December 31, 1942, the tax previously determined will be the sum of the amount shown as the tax by the taxpayer upon his return and the amounts previously assessed (or collected without assessment) as deficiencies, reduced by the amount of any rebates made. The amount shown as the tax by the taxpayer upon his return and the amount of any rebates shall be determined in accordance with the provisions of section 271 and the regulations thereunder.

(b) (1) The tax previously determined may consist of tax for any taxable year beginning after December 31, 1931, imposed by chapter 1 and subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code, by the corresponding provisions of prior Revenue Acts, or by any one or more of such provisions.

(2) After the tax previously determined has been ascertained, a recomputation must then be made to ascertain the increase or decrease in tax, if any, resulting from the correction of the error. The difference between the tax previously determined and the tax as recomputed after correction of the error will be the amount of the adjustment.

(c) With the exception of the items upon which the tax previously determined was based and the item or items with respect to which the error was made, no other item shall be considered in computing the amount of the adjustment. If the treatment of any item upon which the tax previously determined was based, or if the application of any provisions of the internal revenue laws with respect to such tax, depends upon the amount of income (e. g., charitable contributions, foreign tax credit, earned income credit) readjustment in these particulars will be necessary as part of the recomputation in conformity with the change in the amount of the income which results from the correct treatment of the item or items in respect of which the error was made.

(d) Any interest or additions to the tax collected as a result of the error shall be taken into account in determining the amount of the adjustment.

(e) The application of section 3801 (d) may be illustrated by the following example:

Example. (1) For the taxable year 1946 a married man with no dependents, who kept his books on the cash receipts and disbursements basis, filed a return (claiming two exemptions) disclosing adjusted gross income of $42,000, deductions amounting to $12,000, and a net income of $30,000. Included among other items in the gross income were salary in the amount of $15,000 and rents accrued but not yet paid in the amount of $5,000. During the taxable year he donated $10,000 to the American Red Cross and in his return claimed a deduction of $6,300 on account thereof, representing the maximum deduction allowable under the 15 percent limitation imposed by section 23 (o) of the Internal Revenue Code for the year 1946. In computing his net income he omitted interest income amounting to $6,000 and neglected to take a deduction for interest paid in the amount of $4,500. The return disclosed a tax liability of $11,970, which was assessed and paid. After the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1946 the Commissioner included the item of rental income amounting to $5,000 in the taxpayer's gross income for the year 1947 and asserted a deficiency for that year. As a result of a final decision of The Tax Court of the United States in 1952 sustaining the deficiency for 1947, an adjustment is authorized for the year 1946.

(2) The amount of the adjustment is computed as follows:

Tax previously determined for 1946	$11,970.00
Net income for 1946 upon which tax previously determined was based	30,000.00
Less: Rents erroneously included	5,000.00
Balance	25,000.00
Adjustment for contributions (add 15 percent of $5,000)	750.00
Net income as adjusted	25,750.00
Tax as recomputed	9,502.38
Tax previously determined	11,970.00
Difference	2,467.62
Amount of adjustment to be refunded or credited	2,467.62

(3) In accordance with the provisions of section 3801 (d), the recomputation to determine the amount of the adjustment does not take into consideration the item of $6,000 representing interest received, which was omitted from gross income, or the item of $4,500 representing interest paid, for which no deduction was allowed.

§ 39.3801 (e) *Statutory provisions; mitigation of effect of limitation and other provisions in income tax cases; adjustment unaffected by other items.*

SEC. 3801. *Mitigation of effect of limitation and other provisions in income tax cases.* * * *

(e) *Adjustment unaffected by other items, etc.* The amount to be assessed and collected in the same manner as a deficiency, or to be refunded or credited in the same manner as an overpayment, under this section, shall not be diminished by any credit or set-off based upon any item, inclusion, deduction, credit, exemption, gain, or loss other than the one which was the subject of the error. Such amount, if paid, shall not be recovered by a claim or suit for refund or suit for erroneous refund based upon any item, inclusion, deduction, credit, exemption, gain, or loss other than the one which was the subject of the error.

§ 39.3801 (e)-1 *Effect of other items on amount of adjustment.* (a) The amount of the adjustment ascertained under section 3801 (d) shall not be diminished by any credit or set-off based upon any item, inclusion, deduction, credit, exemption, or gain or loss with respect to the year as to which the error was made.

(b) The application of section 3801 (e) may be illustrated by the following examples:

Example (1). In the example set forth in § 39.3801 (d)-1, if, after the amount of the adjustment has been ascertained, the taxpayer filed a refund claim for the amount thereof, the Commissioner could not diminish the amount of that claim by offsetting against it the amount of tax which should have been paid with respect to the $6,000 interest item omitted from gross income for the year 1946; nor could the court, if suit were brought on such claim for refund, offset against the amount of the adjustment the amount of tax which should have been paid with respect to such interest.

Example (2). Assume that a taxpayer included in his gross income for the year 1953 an item which should have been included in gross income for the year 1952. After expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1952 the taxpayer filed a claim for refund for the year 1953 on the ground that such item was not properly includible in gross income for that year. The claim for refund was allowed by the Commissioner and as a result of such determination an adjustment was authorized under section 3801 with respect to the tax for 1952. If, in such case, the Commissioner issued a notice of deficiency for the amount of the adjustment and the taxpayer contested the deficiency before The Tax Court of the United States, the taxpayer could not in such proceeding claim an offset based upon his failure to take an allowable deduction for the year 1952; nor could the Tax Court in its decision offset against the amount of the adjustment any overpayment for the year 1952 resulting from the failure to take such deduction.

(c) If the Commissioner has refunded the amount of an adjustment under section 3801, the amount so refunded may not subsequently be recovered by the Commissioner in a suit for erroneous refund based upon any item, inclusion, deduction, credit, exemption, gain, or loss (other than the one which was the subject of the error) with respect to the year as to which the error was made.

Example. In the example set forth in § 39.3801 (d)-1, if the Commissioner had refunded the amount of the adjustment, no part of the amount so refunded could subsequently be recovered by the Commissioner by a suit for erroneous refund based on the ground that there was no overpayment for 1946, as the taxpayer had failed to include in gross income the $6,000 item of interest received in that year.

(d) If the Commissioner has assessed and collected the amount of an adjustment, no part thereof may be recovered by the taxpayer in any suit for refund based upon any item, inclusion, deduction, credit, exemption, gain, or loss (other than the one which was the subject of the error) with respect to the year as to which the error was made.

Example. In example (2) of paragraph (b) of this section, if the taxpayer had paid the amount of the adjustment, he could not subsequently recover any part of such payment in a suit for refund based upon his

failure to take an allowable deduction for the year 1952.

(e) If the amount of the adjustment is considered as an overpayment, it may be credited, under the applicable law and regulations thereunder, against any income or excess-profits tax, or installment thereof, due from the taxpayer. Likewise, if the amount of the adjustment is considered as a deficiency, any overpayment by the taxpayer of income or excess-profits tax may be credited against the amount of such adjustment in accordance with the applicable law and regulations thereunder. See section 322 of the Internal Revenue Code and the corresponding provisions of prior revenue acts. Accordingly, it may be possible in one transaction between the Commissioner and the taxpayer to settle the taxpayer's tax liability for the year with respect to which the determination is made and to make the adjustment under section 3801 for the year with respect to which the error was made.

§ 39.3801 (f)–(g) *Statutory provisions; mitigation of effect of limitation and other provisions in income tax cases; no adjustment for years prior to 1932; not applicable to taxes imposed by chapter 9.*

SEC. 3801. *Mitigation of effect of limitation and other provisions in income tax cases.* * * *

(f) *No adjustment for years prior to 1932.* No adjustment shall be made under this section in respect of any taxable year beginning prior to January 1, 1932.

(g) *Taxes imposed by chapter 9.* The provisions of this section shall not be construed to apply to any tax imposed by chapter 9.

[Sec. 3801 (g) as added by sec. 208 (c), Social Security Act Amendments 1950]

§ 39.3804 *Statutory provisions; time for performing certain acts postponed by reason of war*

SEC. 3804. *Time for performing certain acts postponed by reason of war*—(a) *Individuals.* The period of time after December 6, 1941, during which an individual is continuously outside the Americas (if such period is longer than ninety days), and the next ninety days thereafter, shall be disregarded in determining, under the internal revenue laws, in respect of any tax liability (including any interest, penalty, additional amount, or addition to the tax) of such individual—

(1) Whether any of the following acts was performed within the time prescribed therefor:

(A) Filing any return of income, estate, or gift tax (except income tax withheld at source an income tax imposed by Chapter 9 or any law superseded thereby);

(B) Payment of any income, estate, or gift tax (except income tax withheld at source and income tax imposed by Chapter 9 or any law superseded thereby) or any installment thereof or of any other liability to the United States in respect thereof;

(C) Filing a petition with the Board of Tax Appeals for redetermination of a deficiency, or for review of a decision rendered by the Board;

(D) Allowance of a credit or refund of any tax;

(E) Filing a claim for credit or refund of any tax;

(F) Bringing a suit upon any such claim for credit or refund;

(G) Assessment of any tax;

(H) Giving or making any notice or demand, for the payment of any tax, or with respect to any liability to the United States in respect of any tax;

(I) Collection, by the Commissioner or the collector, by distraint or otherwise, of the amount of any liability in respect of any tax;

(J) Bringing suit by the United States, or any officer on its behalf, in respect of any liability in respect of any tax; and

(K) Any other act required or permitted under the internal revenue laws specified in regulations prescribed under this section by the Commissioner with the approval of the Secretary;

(2) The amount of any credit or refund (including interest).

(b) *Other taxpayers and other circumstances.* In any case to which subsection (a) does not apply in which it is determined by the Commissioner, under regulations prescribed by him with the approval of the Secretary, that—

(1) By reason of an individual being outside the Americas, or

(2) By reason of any locality (within or without the Americas) being an area of enemy action or being an area under the control of the enemy, as determined by the Commissioner, or

(3) By reason of an individual in the military or naval forces of the United States being outside the States of the Union and the District of Columbia, it is impossible or impracticable to perform any one or more of the acts specified in subsection (a), then in determining, under the internal-revenue laws whether such act was performed within the time prescribed therefor, in respect of any tax liability (including any interest, penalty, additional amount, or addition to tax) affected by the failure to perform such act within such time, and in determining the amount of any credit or refund (including interest) affected by such failure, there shall be disregarded such period after December 6, 1941, as may be prescribed by such regulations.

(c) *Limitation on time to be disregarded.* The period of time disregarded under this section shall not extend beyond the date specified in clause (1) or clause (2) of this subsection, whichever is the earlier:

(1) December 31, 1947, or such date later than December 31, 1947, as the Commissioner may fix in any case in which he makes a determination under subsection (b) if such determination is made after the date this subsection as amended takes effect and is based on the existence prior to January 1, 1948, of one or more of the circumstances specified in paragraph (1), (2), or (3) of subsection (b); or

(2) In the case of an individual with respect to whom a period of time is disregarded under this section, the fifteenth day of the third month following the month in which an executor, administrator, or a conservator of the estate of such individual qualifies.

(d) *Exceptions*—(1) *Tax in jeopardy; bankruptcy and receiverships; and transferred assets.* Notwithstanding the provisions of subsection (a) or (b), any action or proceeding authorized by section 146 (regardless of the taxable year for which the tax arose), 273, 274, 311, 872, 900, 1013, 1015, 1025, or 3660, as well as any other action or proceeding authorized by law in connection therewith, may be taken, begun, or prosecuted. In any other case in which the Commissioner determines that collection of the amount of any assessment would be jeopardized by delay, the provisions of subsections (a) and (b) shall not operate to stay collection of such amount by distraint or otherwise as authorized by law. There shall be excluded from any amount assessed or collected pursuant to this paragraph the amount of interest, penalty, additional amount, and addition to the tax, if any, in respect of the period disregarded under subsection (a) or (b). In any case to which this paragraph relates, if the Commissioner or collector is required to give any notice to or make any demand upon any person, such requirement shall be deemed to be satisfied if the notice or demand is prepared and signed, in any case in which the address of such person last known to the Commissioner or collector is in an area for which United States post offices under instructions of the Postmaster General are not, by reason of the war, accepting mail for delivery at the time the notice or demand is signed. In such case the notice or demand shall be deemed to have been given or made upon the date it is signed.

(2) *Action taken before ascertainment of right to benefits.* The assessment or collection of any internal revenue tax or of any liability to the United States in respect of any internal revenue tax, or any action or proceeding by or on behalf of the United States in connection therewith, may be made, taken, begun, or prosecuted in accordance with law, without regard to the provisions of subsection (a) or (b), unless prior to such assessment, collection, action, or proceeding it is ascertained that the person concerned is entitled to the benefits of subsection (a) or (b).

(3) *Expiration of period of limitations prior to enactment of this section.* This section shall not operate to extend the time for performing any act specified in subsection (a) (1) (G), (H), (I), or (J) if such time under the law in force prior to the date of enactment of this section expired prior to such date.

(e) *Definitions.* For purposes of this section—

(1) *Americas.* The term "Americas" means North, Central, and South America (including the West Indies but not Greenland), and the Hawaiian Islands.

(2) *When individual ceases to be outside Americas or within an area of enemy action.* For the purpose of determining whether any act specified in subsection (a) (1) (G), (H), (I), or (J) was performed within the time prescribed therefor, if any period of time is disregarded under this section by reason of any individual being outside the Americas or within an area of enemy action or control, such individual shall not, if he returns to the Americas or leaves such area after the date of enactment of this section, be deemed to have returned to the Americas or ceased to be within such area before the date upon which the Commissioner receives from such individual a notice thereof in such form as the Commissioner, with the approval of the Secretary, shall by regulations prescribe. A similar rule shall be applied in the case of a member of the military or naval forces of the United States with respect to whom a period of time is disregarded under this section by reason of being outside the States of the Union and the District of Columbia.

(3) *When executor, administrator, or conservator qualifies.* For the purpose of determining whether any act specified in subsection (a) (1) (G), (H), (I), or (J) was performed within the time prescribed therefor, the month in which an executor, administrator, or conservator qualifies, if he qualifies after the date of enactment of this section, shall be deemed to be the month in which the Commissioner receives from him a notice thereof in such form as the Commissioner, with the approval of the Secretary, shall by regulations prescribe.

(f) *Additional time to be disregarded.* In the case of an individual serving in the Armed Forces of the United States, or serving in support of such Armed Forces, in an area designated by the President of the United States by Executive order as a "com-

bat zone" for the purposes of section 22 (b) (13), at any time during the period designated by the President by Executive order as the period of combatant activities in such zone for the purposes of such section, or hospitalized outside the States of the Union and the District of Columbia as a result of injury received while serving in such an area during such time, the period of time disregarded under this section, notwithstanding the limitations of subsections (a) and (c), shall include the period of service in such area, plus the period of continuous hospitalization outside the States of the Union and the District of Columbia attributable to such injury, and the next one hundred and eighty days thereafter.

[Sec. 3804 as added by sec. 507 (a), Rev. Act 1942; amended by sec. 13, Pub. Law 384 (80th Cong.); Pub. Law 908 (81st Cong.)]

§ 39.3805 *Statutory provisions; income tax due dates postponed in case of China Trade Act corporations.*

SEC. 3805. *Income tax due dates postponed in case of China Trade Act corporations.* In the case of any taxable year beginning after December 31, 1948, and ending before October 1, 1953, no Federal income tax return of, or payment of any Federal income tax by, any corporation organized under the China Trade Act of 1922 (42 Stat. 849, U. S. C., Title 15, chapter 4), as amended, shall become due until December 31, 1953, but only with respect to any such corporation and any such taxable year which the Secretary may determine reasonable under the circumstances in China pursuant to such regulations as he may prescribe. Such due date shall be subject to the power of the Secretary to extend the time for filing such return or paying such tax, as in other cases.

[Sec. 3805 as added by sec. 507 (a), Rev. Act 1942; sec. 14, Pub. Law 384 (80th Cong.); sec. 614, Rev. Act 1951]

§ 39.3805-1 *China Trade Act corporations.* (a) with respect to a taxable year ending before October 1, 1953, the Federal income tax return of, or the payment of Federal income tax by, a corporation organized under the China Trade Act of 1922 (15 U. S. C., c. 4) shall not become due until December 31, 1953, if, in the case of any such taxable year of any such corporation, the application of such posponed due date is determined by the Secretary under regulations to be reasonable in view of the circumstances in China.

(b) The due date thus prescribed is expressly subject to the power of the Commissioner to extend, as in other cases, the time for filing the income tax return or paying the income tax. See sections 53 (a) (2) and 56 (c) (1) and the regulations thereunder. See also section 3804 and the regulations thereunder.

(c) The postponement of the due date to December 31, 1953, permitted by section 3805 shall apply with respect to—

(1) A taxable year ending before October 1, 1953, of any corporation organized under the China Trade Act of 1922 if during such taxable year conditions in China have been generally so unsettled as to militate against the normal commercial operations and corporate activities of such corporation, except—

(i) In the case of any such taxable year of any such corporation in respect to which the situation is such that, despite such unsettled conditions, the books of account and business records are available so as to permit the filing of a proper return and the corporation has otherwise been in a position to carry on its commercial operations and corporate activities and to make a proper distribution of its earnings or profits, if any, so as to permit the certification required by section 262 (b), or

(ii) In the case of any such taxable year of any such corporation during which all the commercial operations and corporate activities of such corporation have been carried on in Hong Kong, Macao, or Taiwan; and

(2) Any such taxable year of any such corporation excepted under subparagraph (1) of this paragraph in respect of which the corporation satisfies the Commissioner that special circumstances exist, related to the unsettled conditions in China, which warrant such postponement.

§ 39.3806 *Statutory provisions; mitigation of effect of renegotiation of war contracts or disallowance of reimbursement.*

SEC. 3806. *Mitigation of effect of renegotiation of war contracts or disallowance of reimbursement*—(a) *Reduction for prior taxable year*—(1) *Excessive profits eliminated for prior taxable year.* In the case of a contract with the United States or any agency thereof, or any subcontract thereunder, which is made by the taxpayer, if a renegotiation is made in respect of such contract or subcontract and an amount of excessive profits received or accrued under such contract or subcontract for a taxable year (hereinafter referred to as "prior taxable year") is eliminated and, in a taxable year ending after December 31, 1941, the taxpayer is required to pay or repay to the United States or any agency thereof the amount of excessive profits eliminated or the amount of excessive profits eliminated is applied as an offset against other amounts due the taxpayer, the part of the contract or subcontract price which was received or was accrued for the prior taxable year shall be reduced by the amount of excessive profits eliminated. For the purposes of this section—

(A) The term "renegotiation" includes any transaction which is a renegotiation within the meaning of the Federal renegotiation act applicable to such transaction, any modification of one or more contracts with the United States or any agency thereof, and any agreement with the United States or any agency thereof in respect of one or more such contracts or subcontracts thereunder.

(B) The term "excessive profits" includes any amount which constitutes excessive profits within the meaning assigned to such term by the applicable Federal renegotiation act, any part of the contract price of a contract with the United States or any agency thereof, any part of the subcontract price of a subcontract under such a contract, and any profits derived from one or more such contracts or subcontracts.

(C) The term "subcontract" includes any purchase order or agreement which is a subcontract within the meaning assigned to such term by the applicable Federal renegotiation act.

(D) The term "Federal renegotiation act" includes section 403 of the Sixth Supplemental National Defense Appropriation Act (Public 528, 77th Cong., 2d Sess.), as amended or supplemented, the Renegotiation Act of 1948, as amended or supplemented, and the Renegotiation Act of 1951, as amended or supplemented.

(2) *Reduction of reimbursement for prior taxable year.* In the case of a cost-plus-a-fixed-fee contract between the United States or any agency thereof and the taxpayer, if an item for which the taxpayer has been reimbursed is disallowed as an item of cost chargeable to such contract and, in a taxable year beginning after December 31, 1941, the taxpayer is required to repay the United States or any agency thereof the amount disallowed or the amount disallowed is applied as an offset against other amounts due the taxpayer, the amount of the reimbursement of the taxpayer under the contract for the taxable year in which the reimbursement for such item was received or was accrued (hereinafter referred to as "prior taxable year") shall be reduced by the amount disallowed.

(3) *Deduction disallowed.* The amount of the payment, repayment, or offset described in paragraph (1) or paragraph (2) shall not constitute a deduction for the year in which paid or incurred.

(4) *Exception.* The foregoing provisions of this subsection shall not apply in respect of any contract if the taxpayer shows to the satisfaction of the Commissioner that a different method of accounting for the amount of the payment, repayment, or disallowance clearly reflects income, and in such case the payment, repayment, or disallowance shall be accounted for with respect to the taxable year provided for under such method, which for the purposes of subsections (b) and (c) shall be considered a prior taxable year.

(b) *Credit against repayment on account of renegotiation or allowance*—(1) *General rule.* There shall be credited against the amount of excessive profits eliminated the amount by which the tax for the prior taxable year under Chapter 1, Chapter 2A, Chapter 2B, Chapter 2D, and Chapter 2E, is decreased by reason of the application of paragraph (1) of subsection (a); and there shall be credited against the amount disallowed the amount by which the tax for the prior taxable year under Chapter 1, Chapter 2A, Chapter 2B, Chapter 2D, and Chapter 2E, is decreased by reason of the application of paragraph (2) of subsection (a).

(2) *Special rules as to individuals for 1942 and 1943.* * * * [Not applicable]

(3) *Credit for barred year.* If at the time of the payment, repayment, or offset described in paragraph (1) or paragraph (2) of subsection (a), refund or credit of tax under Chapter 1, Chapter 2A, Chapter 2B, Chapter 2D, or Chapter 2E, for the prior taxable year, is prevented (except for the provisions of section 3801) by any provision of the internal-revenue laws other than section 3761, or by rule of law, the amount by which the tax for such year under such chapters is decreased by the application of paragraph (1) or paragraph (2) of subsection (a) shall be computed under this paragraph. There shall first be ascertained the tax previously determined for the prior taxable year. The amount of the tax previously determined shall be the excess of—

(1) The sum of (A) the amount shown as the tax by the taxpayer upon his return (determined as provided in section 271 (b) (1) and (3)), if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over—

(2) The amount of rebates, as defined in section 271 (b) (2), made.

There shall then be ascertained the decrease in tax previously determined which results solely from the application of paragraph (1) or paragraph (2) of subsection (a) of the prior taxable year. The amount so ascertained, together with any amounts collected as additions to the tax or interest, as a result of paragraph (1) or paragraph (2) of subsection (a) not having been applied to

the prior taxable year shall be the amount by which such tax is decreased.

(4) *Interest.* In determining the amount of credit under this subsection no interest shall be allowed with respect to the amount ascertained under paragraph (1) or paragraph (2); except that if interest is charged by the United States or the agency thereof on account of the disallowance for any period before the date of the payment, repayment, or offset, the credit shall be increased by an amount equal to interest on the amount ascertained under either such paragraph at the same rate and for the period (prior to the date of the payment, repayment, or offset) as interest is so charged.

(c) *Credit in lieu of other credit or refund.* If a credit is allowed under subsection (b) with respect to a prior taxable year no other credit or refund under the internal-revenue laws founded on the application of subsection (a) shall be made on account of the amount allowed with respect to such taxable year. If the amount allowable as a credit under subsection (b) exceeds the amount allowed under such subsection, the excess shall, for the purposes of the internal-revenue laws relating to credit or refund of tax, be treated as an overpayment for the prior taxable year which was made at the time the payment, repayment, or offset was made.

[Sec. 3806 as added by sec. 508, Rev. Act 1942; amended by sec. 701 (c) (1), (2), and (3), Rev. Act 1943; sec. 14 (b), Individual Income Tax Act 1944; sec. 203 Pub. Law 9 (82d Cong.)]

§ 39.3809 *Statutory provisions; verification of returns; penalties of perjury.*

SEC. 3809. *Verification of returns; penalties of perjury*—(a) *Penalties.* Any person who willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter, shall be guilty of a felony, and, upon conviction thereof, shall be fined not more than $2,000 or imprisoned not more than five years, or both.

(b) *Signature presumed correct.* The fact that an individual's name is signed to a return, statement, or other document filed shall be prima facie evidence for all purposes that the return, statement, or other document was actually signed by him.

(c) *Verification in lieu of oath.* The Commissioner, under regulations prescribed by him with the approval of the Secretary, may require that any return, statement, or other document required to be filed under any provision of the internal revenue laws shall contain or be verified by a written declaration that it is made under the penalties of perjury, and such declaration shall be in lieu of any oath otherwise required.

[Sec. 3809 as added by sec. 4 (a), Pub. Law 271 (81st Cong.)]

§ 39.3809-1 *Verification by declaration in lieu of oath.* If the form officially prescribed for any internal revenue return, statement, or other document contains therein provisions for verification by a written declaration that such return, statement, or other document is made under penalties of perjury, such return, statement, or other document shall be verified by the execution of such declaration, and such declaration so executed shall be in lieu of any oath otherwise required for verification by law or by regulations (including Treasury decisions) prescribed by the Commissioner with the approval of the Secretary.

§ 39.3810 *Statutory provisions; effective date of self-employment tax in Puerto Rico.*

SEC. 3810. *Effective date in case of Puerto Rico.* If the Governor of Puerto Rico certifies to the President of the United States that the legislature of Puerto Rico has, by concurrent resolution, resolved that it desires the extension to Puerto Rico of the provisions of Title II of the Social Security Act, the effective date referred to in sections 1426 (e), 481 (a) (7), and 481 (b) shall be January 1 of the first calendar year which begins more than ninety days after the date on which the President receives such certification.

[Sec. 3810 as added by sec. 208 (b), Social Security Act Amendments 1950]

§ 39.3810-1 *Effective date of self-employment tax in Puerto Rico.* Since the Governor of Puerto Rico has certified to the President of the United States that the Legislature of Puerto Rico has, by concurrent resolution, resolved that it desires the extension to Puerto Rico of the provisions of Title II of the Social Security Act, the certificate having been received by the President on September 28, 1950, the effective date specified in section 3810 is January 1, 1951. See § 39.481-1 (c) (7)

§ 39.3811-3812 *Statutory provisions; collection of taxes in Puerto Rico and Virgin Islands; mitigation of effect of statute of limitations and other provisions in case of related taxes under different chapters.*

SEC. 3811. *Collection of taxes in Puerto Rico and Virgin Islands*—(a) *Puerto Rico.* Notwithstanding any other provision of law respecting taxation in Puerto Rico, all taxes imposed by chapter 1, and by subchapters A and D of chapter 9, shall be collected under the direction of the Secretary and shall be paid into the Treasury of the United States as internal revenue collections. All provisions of the laws of the United States applicable to the administration, collection, and enforcement of any tax imposed upon the incomes of individuals, estates, and trusts by chapter 1 (including the provisions relating to The Tax Court of the United States), and of any tax imposed by subchapter A or by subchapter D of chapter 9, shall, in respect to such tax, extend to and be applicable in Puerto Rico in the same manner and to the same extent as if Puerto Rico were a State, and as if the term "United States" when used in a geographical sense included Puerto Rico.

(b) *Virgin Islands.* Notwithstanding any other provision of law respecting taxation in the Virgin Islands, all taxes imposed by subchapter E of chapter 1, and by subchapter A of chapter 9, shall be collected under the direction of the Secretary and shall be paid into the Treasury of the United States as internal revenue collections. All provisions of the laws of the United States applicable to the administration, collection, and enforcement of the tax imposed by subchapter E of chapter 1 (including the provisions relating to The Tax Court of the United States), and of any tax imposed by subchapter A of chapter 9, shall, in respect to such tax, extend to and be applicable in the Virgin Islands in the same manner and to the same extent as if the Virgin Islands were a State, and as if the term "United States" when used in a geographical sense included the Virgin Islands.

(c) *Definition.* As used in this section, the term "tax" includes any penalty with respect to the tax, any addition to the tax, and any additional amount with respect to the tax, provided for by any law of the United States.

[Sec. 3811 as added by sec. 208 (b), Social Security Act Amendments 1950; as amended by sec. 221 (i), Rev. Act 1950]

SEC. 3812. *Mitigation of effect of statute of limitations and other provisions in case of related taxes under different chapters*—(a) *Self-employment tax and tax on wages.* In the case of the tax imposed by subchapter E of chapter 1 (relating to tax on self-employment income) and the tax imposed by section 1400 of subchapter A of chapter 9 (relating to tax on employees under the Federal Insurance Contributions Act)—

(1) (i) If an amount is erroneously treated as self-employment income, or

(ii) If an amount is erroneously treated as wages, and

(2) If the correction of the error would require an assessment of one such tax and the refund or credit of the other tax, and

(3) If at any time the correction of the error is authorized as to one such tax but is prevented as to the other tax by any law or rule of law (other than section 3761, relating to compromises),

then, if the correction authorized is made, the amount of the assessment, or the amount of the credit or refund, as the case may be, authorized as to the one tax shall be reduced by the amount of the credit or refund, or the amount of the assessment, as the case may be, which would be required with respect to such other tax for the correction of the error if such credit or refund, or such assessment, of such other tax were not prevented by any law or rule of law (other than section 3761, relating to compromises).

(b) *Definitions.* For the purposes of subsection (a) of this section, the terms "self-employment income" and "wages" shall have the same meaning as when used in section 481 (b).

[Sec. 3812 as added by sec. 208 (b), Social Security Act Amendments 1950]

§ 39.3812-1 *Application of section.* (a) Section 3812 may be applied in the correction of a certain type of error involving both the tax on self-employment income and the employee tax under section 1400 if the correction of the error as to one tax is, on the date the correction is authorized, prevented in whole or in part by the operation of any law or rule of law other than section 3761, relating to compromises. Examples of such law are sections 275, 311 (b) and (c) 332 (b) and (d), 1117 (e), 1635, 1636, 3746, and 3772; sections 272 (f) and 322 (c), section 3760; and sections 3770 (a) (2) 3774, and 3775.

(b) If the liability for either tax with respect to which the error was made has been compromised under section 3761, the provisions of section 3812 limiting the correction with respect to the other tax do not apply.

(c) Section 3812 is not applicable if, on the date of the authorization, correction of the effect of the error is permissible as to both taxes without recourse to such section.

(d) If, because an amount of wages (as defined in section 1426 (a)) is erroneously treated as self-employment income (as defined in section 481 (b)), or an amount of self-employment income is erroneously treated as wages, it is necessary in correcting the error to assess the correct tax and give a credit or refund

for the amount of the tax erroneously paid, and either, but not both, of such adjustments is prevented by any law or rule of law (other than section 3761) the amount of the assessment or of the credit or refund authorized shall reflect the adjustment which would be made in respect of the other tax (either the tax on self-employment income under section 480 or the employee tax under section 1400) but for the operation of such law or rule of law. For example, assume that during 1952 A paid $10 as tax on an amount erroneously treated as "wages" when such amount was actually self-employment income, and that credit or refund of the $10 is not barred. A should have paid a self-employment tax of $15 on the amount. If the assessment of the correct tax, that is, $15, is barred by the statute of limitations, no credit or refund of the $10 shall be made without offsetting against such $10 the $15, assessment of which is barred. Thus, no credit or refund in respect of the $10 can be made.

(e) As another example, assume that during 1952 a taxpayer reports wages of $3,600 and net earnings from self-employment of $900. By reason of the limitations of section 481 (b) he shows no self-employment income. Assume further that by reason of a final decision by The Tax Court of the United States, further adjustments to his income tax liability are barred. The question of the amount of his wages, as defined in section 1426, was not in issue in the Tax Court litigation, but it is subsequently determined (within the period of limitations applicable under the Federal Insurance Contributions Act) that $700 of the $3,600 reported as wages were not for employment as defined in section 1426 (b) and he is entitled to the allowance of a refund of the $10.50 tax paid on such remuneration under section 1400. The reduction of his wages from $3,600 to $2,900 would result in the determination of $700 self-employment income, the tax on which is $15.75 for the year. The overpayment of $10.50 would be offset under section 3812 by the barred deficiency of $15.75, thus eliminating the refund otherwise allowable. If the facts were changed so that the taxpayer erroneously paid tax on self-employment income of $700, having been taxed on only $2,900 as wages, and within the period of limitations applicable under the Federal Insurance Contributions Act, it is determined that his wages were $3,600, the tax of $10.50 under section 1400, otherwise collectible, would be eliminated by offsetting under section 3812 the barred overpayment of $15.75. The balance of the barred overpayment, $5.25, cannot be credited or refunded.

(b) Another illustration of the operation of this section is the case of a taxpayer who, for 1952, is erroneously taxed on $2,500 as wages, the tax on which is $37.50, and who reports no self-employment income. After the statute of limitations has run on the refund of the tax under the Federal Insurance Contributions Act, it is determined that the amount treated as wages should have been reported as net earnings from self-employment. The taxpayer's self-employment income would then be $2,500 and the tax thereon would be $56.25. Assume that the period of limitations under chapter 1 has not expired, and that a notice of deficiency may properly be issued. Under section 3812, the amount of the deficiency of $56.25 must be reduced by the barred overpayment of $37.50.

§ 39.3812-2 *Law applicable in determination of error* The question of whether there was an erroneous treatment of self-employment income or of wages is determined under the provisions of law and regulations applicable with respect to the year or other taxable period as to which the error was made. The fact that the error was in pursuance of an interpretation, either judicial or administrative, accorded such provisions of law and regulations at the time of such action is not necessarily determinative of this question. For example, if a later judicial decision authoritatively alters such interpretation so that such action was contrary to such provisions of the law and regulations as later interpreted, the error is within the meaning of section 3812.

§ 39.3813 *Statutory provisions; requirements for exemption of certain organizations under section 101 (6) and for deductibility of contributions made to such organizations.*

SEC. 3813. *Requirements for exemption of certain organizations under section 101 (6) and for deductibility of contributions made to such organizations*—(a) *Organizations to which section applies.* This section shall apply to any organization described in section 101 (6) except—

(1) A religious organization (other than a trust);

(2) An educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on;

(3) An organization which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 101 (6)) from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public;

(4) An organization which is operated, supervised, controlled, or principally supported by a religious organization (other than a trust) which is itself not subject to the provisions of this section; and

(5) An organization the principal purposes or functions of which are the providing of medical or hospital care or medical education or medical research.

(b) *Prohibited transactions.* For the purposes of this section, the term "prohibited transaction" means any transaction in which an organization subject to the provisions of this section—

(1) Lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;

(2) Pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

(3) Makes any part of its services available on a preferential basis to;

(4) Makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;

(5) Sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

(6) Engages in any other transaction which results in a substantial diversion of its income or corpus to;

the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in section 24 (b) (2) (D)) of an individual who is the creator of such trust or who has made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 per centum or more of the total combined voting power of all classes of stock entitled to vote or 50 per centum or more of the total value of shares of all classes of stock of the corporation.

(c) *Denial of exemption to organizations engaged in prohibited transactions*—(1) *General rule.* No organization subject to the provisions of this section which has engaged in a prohibited transaction after July 1, 1950, shall be exempt from taxation under section 101 (6).

(2) *Taxable years affected.* An organization shall be denied exemption from taxation under section 101 (6) by reason of paragraph (1) only for taxable years subsequent to the taxable year during which it is notified by the Secretary that it has engaged in a prohibited transaction, unless such organization entered into such prohibited transaction with the purpose of diverting corpus or income of the organization from its exempt purposes, and such transaction involved a substantial part of the corpus or income of such organization.

(d) *Future status of organization denied exemption.* Any organization denied exemption under section 101 (6) by reason of the provisions of subsection (c), with respect to any taxable year following the taxable year in which notice of denial of exemption was received, may, under regulations prescribed by the Secretary, file claim for exemption, and if the Secretary, pursuant to such regulations, is satisfied that such organization will not knowingly again engage in a prohibited transaction, such organization shall be exempt with respect to taxable years subsequent to the year in which such claim is filed.

(e) *Disallowance of certain charitable, etc., deductions.* No gift or bequest for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and the prevention of cruelty to children or animals), otherwise allowable as a deduction under section 23 (o) (2), 23 (q) (2), 162 (a), 505 (a) (2), * * * shall be allowed as a deduction if made to an organization which, in the taxable year of the organization in which the gift or bequest is made, is not exempt under section 101 (6) by reason of the provisions of this section. With respect to any taxable year of the organization for which the organization is not exempt pursuant to the provisions of subsection (c) by reason of having engaged in a prohibited transaction with the purpose of diverting the corpus or income of such organization from its exempt purposes and such transaction involved a substantial part of such corpus or income, and which taxable year is the same, or prior to the, taxable year of the organization in which such transaction occurred, such deduction shall be disallowed the donor only if such donor or (if such donor is an individual) any member of his family (as defined in section 24 (b) (2) (D)) was a party to such prohibited transaction.

(f) *Definition.* For the purposes of this section, the term "gift or bequest" means any

gift, contribution, bequest, devise, legacy, or transfer.

[Sec. 3813 as added by sec. 331, Rev. Act 1950]

§ 39.3813-1 *Denial of exemption to organizations engaged in prohibited transactions.* (a) The prohibited transactions enumerated in section 3813 (b) are in addition to and not in limitation of the restrictions contained in section 101 (6) Even though an organization has not engaged in any of the prohibited transactions referred to in section 3813 (b) it still may not qualify for tax exemption in view of the general provisions of section 101 (6) Thus, if a trustee or other fiduciary of the organization (whether or not he is also a creator of such organization) enters into a transaction with the organization, such transaction will be closely scrutinized in the light of the fiduciary principle requiring undivided loyalty to ascertain whether the organization is in fact being operated for the stated exempt purposes.

(b) An organization described in section 101 (6) other than an organization excepted by section 3813 (a), which has engaged in any prohibited transaction (as described in section 3813 (b)) after July 1, 1950, shall not be exempt from taxation under section 101 (6) for any taxable year subsequent to the taxable year in which there is mailed to it a notice in writing by the Commissioner that it has engaged in such prohibited transaction. Such notification by the Commissioner shall be by registered mail to the last known address of the organization. However, notwithstanding the requirement of notification by the Commissioner, exemption shall be denied with respect to any taxable year if such organization during or prior to such taxable year commenced the prohibited transaction with the purpose of diverting income or corpus from its exempt purposes and such transaction involved a substantial part of the income or corpus of such organization. For the purpose of this section, the term "taxable year" means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the "taxable year" of the organization means the calendar year.

(c) The application of section 3813 (b) may be illustrated by the following examples:

Example (1). A creates a foundation in 1949 ostensibly for educational purposes. B, as trustee, accumulates the foundation's income from 1952 until 1955 and then uses a substantial part of this accumulated income to send A's children to college. The foundation would lose its exemption for the taxable years 1952 through 1955 and for subsequent taxable years until it regains its exempt status.

Example (2). If under the facts in example (1) such private benefit was the purpose of the foundation from its inception, such foundation is not exempt by reason of the general provisions of section 101 (6), without regard to the provisions of section 3813, for all years since its inception, that is, for the taxable years 1949 through 1955 and subsequent taxable years, since under section 101 (6) the organization must be organized and operated exclusively for exempt purposes. See § 39.101 (6)-1. See also § 39.3814-1 for loss of exemption in the case of certain organizations accumulating income.

§ 39.3813-2 *Future status of organization denied exemption.* (a) Any organization denied exemption under section 101 (6) by reason of the provisions of section 3813 (c) may file, in any taxable year following the taxable year in which notice of denial of exemption was issued, a claim for exemption with the district director of internal revenue for the internal revenue district in which is located the principal place of business or principal office of the organization. Form 1023, the exemption application, a copy of which may be obtained from any district director of internal revenue, shall be used for this purpose. The claim must contain or have attached to it, in addition to the information generally required of an organization claiming exemption under section 101 (6) an affidavit, by a principal officer of such organization authorized to make such affidavit, that the organization will not knowingly again engage in a prohibited transaction. See § 39.101-1 for proof of exemption requirements in general.

(b) If the Commissioner is satisfied that such organization will not knowingly again engage in a prohibited transaction and that the organization also satisfies all other requirements under section 101 (6) he shall so notify the organization in writing. In such case the organization will be exempt (subject to the provisions of sections 101 (6) 3813, and 3814) with respect to the taxable years subsequent to the taxable year in which such claim is filed. Section 3813 contemplates that an organization denied exemption because of the terms of such section will be subject to taxation for at least one full taxable year. For the purpose of this section, the term "taxable year" means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the "taxable year" of the organization means the calendar year.

§ 39.3813-3 *Disallowance of certain charitable, etc., deductions.* (a) No gift or contribution which would otherwise be allowable as a charitable or other deduction under section 23 (o) (2) 23 (q) (2) 162 (a) or 505 (a) (2) shall be allowed as a deduction if made to an organization which at the time the gift or contribution is made is not exempt under section 101 (6) by reason of the provisions of section 3813.

(b) If an organization, which receives a gift or contribution, is not exempt under section 101 (6) because it engaged in a prohibited transaction involving a substantial part of its income or corpus with the purpose of diverting its income or corpus from its exempt purposes, and if the taxable year of the organization during which such gift or contribution is made is the same as, or is prior to, the taxable year of the organization in which such transaction occurred, then a deduction by the donor with respect to the gift or contribution shall not be disallowed under paragraph (a) of this section unless the donor (or any member of his family if the donor is an individual) is a party to such prohibited transaction. For the purpose of the preceding sentence, the members of an individual donor's family include only his brothers and sisters, whether by whole or half blood, spouse, ancestors, and lineal descendants.

(c) The application of section 3813 (e) may be illustrated by the following example:

Example. In 1952, corporation A, which files its income tax returns on the calendar year basis, creates a foundation purportedly for charitable purposes and deducts from its gross income for that year the amount of the gift to the foundation. Corporation A makes additional gifts to this foundation in 1953, 1954, and 1955, and takes charitable deductions for such years. B, an individual, also contributes to the foundation in 1953, 1954, and 1955, and takes charitable deductions for such years. In 1953, the foundation commences purposely to divert its corpus to the benefit of corporation A, and a substantial amount of such corpus is so diverted by the close of the taxable year 1954. For 1953 and subsequent taxable years, the exemption allowed the foundation under section 101 (6) is denied by reason of the provisions of section 3813 (c). Both corporation A and individual B would be disallowed any deduction for the contributions made during 1955 to the foundation. Moreover, the charitable deductions taken by corporation A for contributions to the foundation in the years 1953 and 1954 would also be disallowed since corporation A was a party to the prohibited transaction. If the facts and surrounding circumstances indicate that the contribution in 1952 by corporation A was for the purpose of the prohibited transaction, then the charitable deduction for the year 1952 shall also be disallowed with respect to corporation A, since the prohibited transaction would then have commenced with the making of such contribution and the exemption allowed the foundation under section 101 (6) would then be denied for 1952 by reason of provisions of section 3813 (e).

§ 39.3814 *Statutory provisions; denial of exemption under section 101 (6) in the case of certain organizations accumulating income.*

SEC. 3814. *Denial of exemption under section 101 (6) in the case of certain organizations accumulating income.* In the case of any organization described in section 101 (6) to which section 3813 is applicable, if the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) Are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for such organization's exemption under section 101 (6); or

(2) Are used to a substantial degree for purposes or functions other than those constituting the basis for such organization's exemption under section 101 (6); or

(3) Are invested in such a manner as to jeopardize the carrying out of the charitable, educational, or other purpose or function constituting the basis for such organization's exemption under section 101 (6),

exemption under section 101 (6) shall be denied for the taxable year.

[Sec. 3814 as added by sec. 331, Rev. Act 1950]

§ 39.3814-1 *Denial of exemption under section 101 (6) in the case of certain organizations accumulating income.* (a) The restrictions enumerated in section 3814 are in addition to and not in

limitation of the restrictions contained in section 101 (6) Even though an organization has not violated any of the terms of section 3814, it still may not qualify for tax exemption in view of the general provisions of section 101 (6) Thus, if a trustee or other fiduciary of the organization (whether or not he is also a creator of such organization) enters into a transaction with the organization, such transaction will be closely scrutinized in the light of the fiduciary principle requiring undivided loyalty to ascertain whether the organization is in fact being operated for the stated exempt purposes.

(b) Any organization described in section 101 (6) other than an organization described in section 3813 (a) (1) through (5) inclusive, shall not be exempt under section 101 (6) if the amounts accumulated out of income during the taxable year, or any prior taxable year, and not actually paid out for exempt purposes by the end of the taxable year, are unreasonable. Amounts accumulated out of income become unreasonable when more income is accumulated than is needed, or when the duration of the accumulation is longer than is needed, in order to carry out the purpose constituting the basis for the organization's exemption. Furthermore, an organization shall not be exempt under section 101 (6) if amounts accumulated out of income are used to a substantial degree for purposes or functions other than those constituting the basis for the organization's exemption, or if such amounts are invested in such a manner as to jeopardize the carrying out of the purpose or function constituting the basis for the organization's exemption.

(c) For the purpose of section 3814, the term "income" means gains, profits, and income determined under the principles applicable in determining the earnings or profits of a corporation. The amount accumulated out of income during the taxable year or any prior taxable year shall be determined under the principles applicable in determining the accumulated earnings or profits of a corporation. In determining the reasonableness of an accumulation out of income, there will be disregarded the following: (1) The accumulation of gain upon the sale or exchange of a donated asset to the extent that such gain represents the excess of the fair market value of such assets when acquired by the organization over its substituted basis in the hands of the organization; (2) the accumulation of gain upon the sale or exchange of property held for the production of investment income, such as dividends, interest, and rents, where the proceeds of such sale or exchange are within a reasonable time reinvested in property acquired and held in good faith for the production of investment income.

(d) Whether the conditions specified in paragraphs (1) (2) and (3) of section 3814 are present in any case must be determined from all the facts. The conditions specified in section 3814 (1) (2) and (3) may result from the use of only one organization or of a chain of two or more organizations.

(e) An organization that has lost its exempt status by reason of the provisions of section 3814 may, in order to reestablish its exemption, file a claim for exemption with the district director of internal revenue for the internal revenue district in which is located the principal place of business or principal office of the organization. Form 1023, the exemption application, a copy of which may be obtained from any district director of internal revenue, shall be used for this purpose. The claim for exemption must contain or be accompanied by information or evidence showing that the circumstances that caused the loss of exemption under section 3814 no longer exist, and an affidavit, by a principal officer of such organization authorized to make such affidavit, that the organization will not knowingly again violate the terms of section 3814. See § 39.101-1 for proof of exemption requirements in general. The provisions of section 3814 contemplate that an organization denied exemption thereunder will be subject to taxation for at least one full taxable year. For the purpose of this section, the term "taxable year" means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the "taxable year" of the organization means the calendar year.

(f) In the case of an organization denied exemption under section 101 (6) solely by reason of the provisions of section 3814, deductions otherwise allowable under section 23 (o) (2) 23 (q) (2), 162 (a), or 505 (a) (2) for gifts or contributions to such organization shall not be disallowed.

§ 39.4041 *Statutory provisions; issue of instructions, regulations, and forms.*

SEC. 4041. *Issue of instructions, regulations, and forms*—(a) *In general.* The Secretary shall prescribe forms of entries, oaths, bonds, and other papers, and rules and regulations, not inconsistent with law, to be used under and in the execution and enforcement of the various provisions of the internal revenue laws; and he shall give such directions to collectors and prescribe such rules and forms to be observed by them as may be necessary for the proper execution of the law.

§ 39.4047 (a) *Statutory provisions; penalties for disclosure of information by officers and employees of the United States.*

SEC. 4047. *Penalties*—(a) *Disclosure of information by officers and employees of the United States*—(1) *Operations of manufacturer or producer.* It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person the operations, style of work, or apparatus of any manufacturer or producer visited by him in the discharge of his official duties; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and the offender shall be dismissed from office or discharged from employment. The provisions of this paragraph shall apply to internal revenue agents as fully as to internal revenue officers.

(2) *Income tax data.* For penalty for disclosing income tax data, see section 55 (f) (1).

SUBPART G—MISCELLANEOUS PROVISIONS

§ 39.6000-1 *Extension of time for making certain elections.* (a) If in the regulations in this part a time is fixed on or before which an election or an application for relief may be made by the taxpayer and such time is not expressly provided in the law, the Commissioner in his discretion may, for good cause shown, except as provided in the next paragraph, grant a reasonable extension of time for the making of such election or application if request for such extension is filed with the Commissioner before the time fixed for making such election or application or within such time thereafter as the Commissioner may consider reasonable under the circumstances and it is shown to the satisfaction of the Commissioner that the granting of the extension will not jeopardize the interests of the Government.

(b) The time fixed in the regulations in this part will not be extended by the Commissioner in such cases as the following: (1) An election required to be made in or with the taxpayer's original income tax return; (2) an election required to be exercised by the filing of a claim for credit or refund unless such election is required to be exercised at a time fixed by the regulations in this part, which time is before the date of the expiration of the period of limitations provided in section 322, or an election required to be filed a petition to the Tax Court; (3) an application for permission to change a previous election; or (4) an application for permission to change an accounting method as described in §§ 39.41-2 and 39.123-1, an application for permission to change an accounting period as described in § 39.46-1, or an application for permission to change the method of treating bad debts as described in § 39.23 (k)-1.

In pursuance of the Internal Revenue Code, the regulations in this part (Regulations 118) are hereby prescribed, applicable to taxable years beginning after December 31, 1951. Such regulations include those provisions contained in Part 29, 26 CFR, 1949 ed., supps. (Regulations 111) which have application to taxable years beginning after December 31, 1951. Because the provisions of the regulations in this part are provisions which have heretofore been prescribed pursuant to the Administrative Procedure Act, approved June 11, 1946, it is found unnecessary to issue such regulations with notice and public procedure thereon under section 4 (a) of the Administrative Procedure Act or subject to the effective date limitation of section 4 (c) of that Act. The regulations in Part 29 (Regulations 111) insofar as they relate to income taxes for taxable years beginning after December 31, 1951, are hereby superseded.

[SEAL] T. COLEMAN ANDREWS,
Commissioner of Internal Revenue.

Approved: September 23, 1953.

G. M. HUMPHREY,
Secretary of the Treasury.

[F. R. Doc. 53-8236; Filed, Sept. 25, 1953; 8:52 a. m.]